

ABOUT THE BOOK

The present book attempts to account for some of the psychological, socio-situational and scholastic predictors of behaviour in a very specific and limited but a very important and unexplored domain of human behaviour namely : involvement in studies. On the basis of this study a model of involvement in studies has been suggested by the author. The book may be of great use and interest to parents, psychologists, teachers and educationists.

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PREDICTORS
OF
STUDENT INVOLVEMENT
IN
STUDIES

PREDICTORS OF STUDENT INVOLVEMENT IN STUDIES

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**DEDICATED
TO
MY PARENTS**

INTRODUCTION

In this age of mass education accompanied with inadequate facilities in schools, impoverished family backgrounds particularly in case of first generation learners, increasing unemployment and the widening gap between the school and the society it is no wonder that a study of predictors of student involvement in studies assumes special significance. Through this study the author has thrown valuable light on the socio-economic and psychological aspects of the problem. Some of the conclusions related to personality characteristics of students having greater involvement in studies like conscientiousness, self discipline, spontaneity, control, social preciseness and a high self concept need special attention. Does it not lead to the conclusion that besides emphasizing academic achievement the home, school and society should take special note of these psychological aspects related to student development and implement educational programmes involving conscious effort to develop these qualities among the adolescent and youth ? This aspect has acquired special importance in the present context of collapsing social and moral values.

Dr. Bhatnagar has executed this study with all the rigour necessary for a scientific investigation. It presents a good model to students pursuing research in education and psychology. The 'Involvement Inventory' which she has developed in this study can be usefully used by other researchers working on similar problems. She has, no doubt, made a significant contribution to the body of knowledge in this extremely important, yet unexplored, area of human behaviour.

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FOREWORD

Psychologists in general and teachers, educational planners and administrators as well as parents in particular are greatly concerned about students' involvement in studies. At every level of curriculum design, involvement of students in studies is taken note of as a core of their motivation to learn.

This study has identified certain intrinsic and extrinsic variables of students' involvement in studies. Personality factors, such as sociability, intelligence, ego-strength, adventurousness, self-control; satisfaction of various needs as well as school subjects by themselves are predictors of the involvement of students in studies. The author has developed a Study Involvement Inventory, which intends to measure the involvement in form of a cumulative index, based on various need areas of the students. This Inventory is a pioneering attempt of the author.

I hope, the work will be appreciated by psychologists and educationists as well as serve as a guide-line for developing various types of educational curricula.

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PREFACE

The present book is based upon my Ph. D thesis on 'A Study of Some Factors Affecting Student Involvement in Studies' awarded by the Indian Institute of Technology, Delhi in 1979.

I wish to express my deep gratitude to Dr. (Mrs.) Purnima Mathur, Head, Department of Humanities and Social Sciences, Indian Institute of Technology, Delhi and Prof. R.G. Misra, the then Head, Department of Measurement and Evaluation, National Council of Educational Research and Training, New Delhi who gave unsparingly of their time, rare understanding and knowledge, inspiration and invaluable guidance for this work.

I am particularly indebted to the National Council of Educational Research and Training, New Delhi for the permission, facilities and contingency grant to undertake this work and for the grant-in-aid as financial assistance for publication of this book.

For computer programmes and analysis of data I am grateful to the Survey and Data Processing Unit of N.C.E.R.T. Computer Centre, IIT, Delhi, Computer Centre, Delhi University and the Computer Centre, Indian Agricultural Research Statistical Institute, New Delhi for their generous help.

I am thankful to the principals and students of various schools of Delhi for their cooperation during data collection for this study.

I also wish to express my thanks to my husband for reading the script and giving assistance in other innumerable ways and to my sons for showing immense understanding and cooperation during this work.

I will feel highly rewarded if this work can help the home, school and society in understanding the various psychological, environmental, social and academic factors related to student development and in implementing such educational programmes which will help develop desirable qualities in students.

ASHA BHATNAGAR

30-9-1981.

CONTENTS

Chapter.

1. Introduction	1—4
2. Theoretical Orientation	5—19
3. Review of Literature	20—35
4. Methodology	36—49
Tools—37	
Sample—44	
Procedure—45	
Statistical Analysis—46	
5. Concept of Involvement in Studies	50—57
6. Results	58—97
Involvement in Studies and Background Variables—60	
Involvement in Studies and Psychological Variables—67	
Involvement in Studies and Scholastic achievement—77	
7. Conclusion and Suggestions	98—102
References—103	
Appendix I—123	
Appendix II—126	
Author Index—129	
Subject Index—132	
Errata—135	

CHAPTER 1

INTRODUCTION

Pointing out the inadequacy of the S-R paradigm in explaining the complex human behaviour, Hebb (1960) states :

“Unless psychologists were willing to move beyond seeking explanation of behaviour solely in terms of stimulus-response relationships—that is, unless they were willing to postulate an ideational process and to study such entities as the self, their contribution to the future understanding of complex human behaviour would be limited”.

The missing ideational process is the motivation or cause of behaviour which according to Gordon (1963).

“Serves two functions, it accounts for why behaviour occurs at all ; and it sustains behaviour until the motive is satisfied”.

Two types of motivations have been identified by psychologists ; extrinsic and intrinsic. Only recently have psychologists directed much attention to the concept of intrinsic motivation. Koch (1956, 1961) is one of the exponents to make strong assertions that motivational theory needs to be revamped to give considerable importance to the notion of intrinsic motivation. He observes :

“When a person engages in an intrinsically motivated activity he becomes fully absorbed in the activity and committed to it. He can tolerate substantive fatigue and suppress primary drives such as hunger”.

This is involvement in the activity. According to Koch (1956) intrinsically motivated behaviour is highly organized, energized and motivated behaviour.

Berlyne (1971) has concentrated on rewarding properties of drive (need) reduction. He has considered arousal to be a general

2 *Predictors of Student Involvement in Studies*

drive state and concludes that behaviour which reduces this would be reinforced. He has asserted that intrinsically motivated behaviours are ones which are aimed at establishing certain internal conditions that are rewarding for the individual. These conditions are bound up with the needs of the brain.

Various needs have been put forth to account for the intrinsic behaviour. Though many psychologists have made 'need' basis to the system of psychology, Murray (1938) has been the first to present a taxonomy of needs. He conceptualizes a hypothetical force (need) within the organism which may be responsible for a behavioural trend.

Psychologists have not only realized the importance of personality variables but they have long recognized the influence of environmental factors in the explanation of behaviour. Theorists have emphasized a variety of terms to describe the necessity of using both sets of concepts. Lewin (1951), for example, illustrates this dual focus in his statement thus :

Behaviour (B) is a function (F) of the person (P) and of his environment (E) or

$$B = F(P, E)$$

Although the person is surrounded by his psychological environment, he is not a part of or included in the environment. However, the boundary between the person and the environment is a permeable one. This means that environmental facts can influence the person,

$$P = F(E)$$

and personal facts can influence the environment,

$$E = F(P).$$

The principal facts of the inner personal region are called needs, while the facts of the psychological environment are called valences.

Need as propounded by Lewin is a motivational concept and is equivalent to such terms as motive, wish, drive and urge. He states that an increase of tension or the release of energy in an inner-personal

region is caused by the arousal of a need. A need may be a physiological condition such as hunger, thirst, or sex ; it may be a desire for something such as a job, or may be intention to do something such as completing a task or keeping an appointment.

A valence, on the other hand, is a conceptual property of a region of the psychological environment. It is the value of that region for a person. There are two kinds of value, positive and negative. A region of positive value is one that contains a goal object which will reduce tension when the person enters the region. A region of negative valence is one that will increase tension. Positive valences attract, negative valences repel.

Lewin's (1935) theory is one of those that has helped to revive the concept of man as a complex energy field, motivated by psychological forces, and behaving selectively and creatively. From his notions, the cognitive approach to motivation has emerged which places primary emphasis on a person's thought processes. The person is conceived of as an information processing system. The cognitive approach assumes that the stimulus value of both internal and external events depends upon the meaning given by the individual who is actively engaged in their organization and interpretation. It emphasizes that cognitive processing is an important determinant of behaviour. This approach views humans as striving to satisfy their needs by setting goals and choosing behaviours that they believe will help them to achieve these goals (Levy, 1970).

Weiner (1972) has proposed that a cognitive model of motivation would included (a) antecedent stimuli, (b) mediating cognitive events, and (c) behaviour. Lewin's theory emphasizes primarily the link between the last two. The question of needs according to him would be included in antecedent stimuli of the model. Deci (1975), however, has stressed that a more complete cognitive theory would focus on the first, as well as on the other characteristics of the model to explain behaviour.

The present study attempts to account for the determinants of the direction, magnitude, and persistence of behaviour in a very specific and limited but a very important domain of human behaviour, namely, involvement in studies, using Deci's model of motivation.

4 *Predictors of Student Involvement in Studies*

An exhaustive review of researches throws no light on the nature of involvement in studies and its relationship with various personality and environmental factors.

Tentatively, involvement in studies will be defined as a specific intrinsic motivational concept which is determined by the number and extent of individual's needs satisfied through studies. It is assumed that this sense of involvement is influenced by many factors, such as, various personality characteristics of the individual, socio-economic background and certain demographical characteristics, as well as scholastic achievement variables.

The main objectives of the present investigation are :

1. to study the relationship of involvement in studies with certain background variables, such as, sex, birth-order, caste, type of school, socio-economic status, and geographical location of school ;
2. to establish the relationship of involvement in studies with the measures of intelligence, level of aspiration, social desirability, and certain personality variables, and scholastic achievement ;
3. to find out the psychological traits of students having high, and low involvement in studies ;
4. to determine the relative contribution of the independent variables in predicting the criterion variable, involvement in studies ;
5. to develop a valid and reliable inventory for measuring student involvement in studies ; and
6. to attempt to evolve a model of involvement in studies on the basis of the findings of this investigation.

CHAPTER 2

THEORETICAL ORIENTATION

Various explanations have been given to the question 'why does an individual behave?' Psycho-analytic theorists have answered the question asserting that people's behaviour is determined by a complex interaction between their unconscious drives and the environment. The behaviourists are concerned with the mechanistic associative links which develop between stimuli and responses through reinforcement of a response in the presence of a stimulus. Cognitive theorists, on the other hand, conceive of the person as an information processing system and his behaviour as decided by his perception and understanding of events and his decision making.

Some of the theories of general and intrinsic motivation, which is the cause of behaviour, are advanced by Murray (1938), Maslow (1943), Atkinson (1964), and Deci (1975).

Theories of Human Motivation

Murray's Personology

The most distinctive feature of Murray's theory (1938) is its highly differentiated and carefully specified treatment of human motivation.

The focus of Murray's personology is upon the individual in all his complexity. He has emphasized consistently the organic quality of behaviour, indicating that a single segment of behaviour is not to be understood in isolation from the rest of the functioning person.

Murray is influenced by field orientation also. He has insisted that the environmental context of behaviour must be thoroughly understood and analyzed before an adequate account of individual behaviour is possible. He has not only emphasized the importance of environmental determinants but, more distinctly, he has developed an elaborate set of concepts designed to represent these forces.

6 Predictors of Student Involvement in Studies

Murray's theory of motivation is based on certain concepts, the most important of which is the need concept which from the beginning has been the focus of his conceptual efforts.

Need : Although the concept of need has been used by other psychologists none has subjected the concept to so careful an analysis nor provided such a complete taxonomy of needs as has Murray. According to Murray :

“a need is a construct (a convenient fiction or hypothetical concept) which stands for a force.....in the brain region, a force which organizes perception, apperception, intellection, conation and action in such a way as to transform in a certain direction an existing, unsatisfying situation. A need is sometimes provoked directly by internal processes of a certain kind..... but, more frequently (when in a state of readiness) by the occurrence of one of a few commonly effective press (environmental forces)..... . Thus it manifests itself by leading the organism to search for or to avoid encountering or, when encountered, to attend and respond to certain kinds of press..... . Each need is characteristically accompanied by a particular feeling or emotion and tends to use certain course of overt behaviour (or fantasy), which....., changes the initiating circumstances in such a way as to bring about an end situation which stills (appeases or satisfies) the organism” (Murray, 1938, pp. 123-124).

The definition clarifies that though an abstract or hypothetical construct, need is linked to underlying physiological processes in the brain. It is also conceived that needs are either internally aroused or set into action as a result of external stimulation. In either case the need produces activity on the part of the organism and maintains this activity until the organism-environment situation has been altered so as to reduce the need. Murray states that the existence of a need can be inferred on the basis of :

- (i) the effect or end result of the behaviour :
- (ii) the particular pattern or mode of behaviour involved ;
- (iii) the selective attention and response to a particular class of a stimulus objects ;
- (iv) the expression of a particular emotion or affect ; and

- (v) the expression of satisfaction when a particular effect is achieved or disappointment when the effect is not achieved (1938, p. 124).

Murray, following the intensive study of a small number of subjects, arrived at a tentative list of twenty needs. These twenty needs are briefly listed and defined as under (Hall and Lindzey, 1970, pp. 176-177) :

- | | |
|---------------|--|
| n Abasement | To submit passively to external force. To accept injury, blame, criticism, punishment. To surrender. To become resigned to fate. To admit inferiority, error, wrongdoing, or defeat. To confess and atone. To blame, belittle, or mutilate the self. To seek and enjoy pain, punishment, illness, and misfortune. |
| n Achievement | To accomplish something difficult. To master, manipulate, or organize physical objects, human beings, or ideas. To do this as rapidly and as independently as possible. To overcome obstacles and attain a high standard. To excel oneself. To rival and surpass others. To increase self-regard by the successful exercise of talent. |
| n Affiliation | To draw near and enjoyably cooperate or reciprocate with an allied other (another who resembles the subject or who likes the subject). To please and win affection of a cathected object. To adhere and remain loyal to a friend. |
| n Aggression | To overcome opposition forcefully. To fight. To revenge an injury. To attack, injure, kill another. To oppose forcefully or punish another. |
| n Autonomy | To get free, shake off restraint, break out of confinement. To resist coercion and |

8 *Predictors of Student Involvement in Studies*

- restriction. To avoid or quit activities prescribed by domineering authorities. To be independent and free to act according to impulse. To be unattached, irresponsible. To defy convention.
- n Counteraction To master or make up for a failure by restriving. To obliterate a humiliation by resumed action. To overcome weaknesses, to repress fear. To efface a dishonor by action. To search for obstacles and difficulties to overcome. To maintain self-respect and pride on a high level.
- n Defenceence To defend the self against assault, criticism, and blame. To conceal or justify a misdeed, failure, or humiliation. To vindicate the ego.
- n Deference To admire and support a superior. To praise, honour, or eulogize. To yield eagerly to the influence of an allied other. To emulate an exemplar. To conform to custom.
- n Dominance To control one's human environment. To influence or direct the behaviour of others by suggestion, seduction, persuasion, or command. To dissuade, restrain, or prohibit.
- n Exhibition To make an impression. To be seen and heard. To excite, amaze, fascinate, entertain, shock, intrigue, amuse, or entice others.
- n Harmavoidance To avoid pain, physical injury, illness, and death. To escape from a dangerous situation. To take precautionary measures.
- n Infavoidance To avoid humiliation. To quit embarrassing situations or to avoid conditions which may lead to belittlement: the scorn, derision,

or indifference of others. To refrain from action because of the fear of failure.

- n Nurturance To give sympathy and gratify the needs of a helpless object : an infant or any object that is weak, disabled, tired, inexperienced, infirm, defeated, humiliated, lonely, dejected, sick, mentally confused. To assist an object in danger. To feed, help, support, console, protect, comfort, nurse, heal.
- n Order To put things in order. To achieve cleanliness, arrangement, organization, balance, neatness, tidiness, and precision.
- n Play To act for 'fun' without further purpose. To like to laugh and make jokes. To seek enjoyable relaxation of stress. To participate in games, sports, dancing, drinking parties, cards.
- n Recognition * To excite praise and commendation. To demand respect. To boast and exhibit one's accomplishments. To seek distinction, social prestige, honours or high office.
- n Rejection To separate oneself from a negatively cathected object. To exclude, abandon, expel, or remain indifferent to an inferior object. To snub or jilt an object.
- n Sentience To seek and enjoy sensuous impressions.
- n Sex To form and further an erotic relationship. To have sexual intercourse.
- n Succorance To have one's needs gratified by the sympathetic aid of an allied object. To be nursed, supported, sustained, surrounded, protected, loved, advised, guided, indulged, forgiven, consoled. To remain close to a devoted protector. To always have a supporter.

n Understanding To ask or answer general questions. To be interested in theory. To speculate, formulate, analyze, and generalize.

*—This need is occasionally referred to but was not systematically used in Murray's study of 1938. This need was, however, included under n—Exhibition.

It is important to distinguish between different types of needs as conceptualized by Murray. There are primary and secondary needs. The primary needs are viscerogenic needs which are linked to characteristic organic events and typically refer to physical satisfaction like needs for air, water, food, etc. The secondary, ego or psychogenic needs are presumably derived from the primary needs and are not connected with any specific organic processes or physical satisfaction, like needs for acquisition, construction, achievement, recognition etc.

Distinction has also been made between overt needs and covert needs, focal needs and diffuse needs, proactive needs and reactive needs.

Murray accepts the fact that there exists a hierarchy of needs with certain tendencies taking precedence over others. The concept of prepotency is used to refer to needs which :

“become regnant with the greatest urgency if they are not satisfied” (Murray, 1951, p. 452).

A minimal satisfaction of prepotent needs is necessary before other needs can operate.

Multiplicity of needs is also emphasized in Murray's theory. Under certain circumstances multiple needs may be gratified by a single course of action. In instances where the outcome of different needs is behaviourally the same, Murray speaks of fusion of needs.

However, these personal motivators are intimately linked with events taking place outside the individual and according to Murray these motivational state of the individual and the operant environmental forces are so closely intertwined that it would be a serious distortion to separate them.

Press : In Murray's theory just as the concept of 'need'

represents the significant determinant of behaviour within the person so the concept of 'press' represents the effective or significant determinant of behaviour in the environment.

It is important to distinguish between the significance of environmental objects as they are perceived or interpreted by the individual (beta press) and the properties of those environmental objects as they exist in reality or as objective enquiry discloses them (alpha press). The individual's behaviour is most closely correlated with the beta press but it is nevertheless important to discover situations in which there is a wide discrepancy between the beta press to which the individual is reacting and the alpha press which actually exist.

Murray accepts the proposition that man acts in such a way as to intend the increase of satisfaction and decrease of tension. However this is only an intention or belief on the actor's part and it does not always turn out that the act, which he believes will reduce tension and lead to satisfaction, is successful in attaining this goal. Moreover, man is not motivated to increase satisfaction in general, it is always a specific tension relevant to a particular need which he is trying to reduce. Satisfaction is thus largely an outcome or result of need states and their behavioural consequences. As Murray suggests :

"need then, is the fundamental variable, and degree of satisfaction the best indicator of its state of progress" (Murray and Kluckhohn, 1953, p. 18).

Obuchowski (1964) has also emphasized the importance of needs in the human life. He states that needs are personal traits that structure an individual's life style and his creative expression.

Maslow has also emphasized the idea of multiple determinants of behaviour. He says :

“Not all behaviour is determined by the basic needs. Even not all behaviour is motivated. There are many determinants of behaviour other than motives. For instance, one other important class of determinants is the so called external field. Theoretically, at least behaviour may be determined completely by the external field or even by specific, isolated, external stimuli, as in association of ideas, or certain conditioned reflexes.

Secondly, we may call attention again to the concept of degree of closeness to the basic needs or degree of motivation. Some behaviour is highly motivated, other behavior is only weakly motivated. Some is not motivated at all (but all behaviour is determined)’’.

Theories of Intrinsic Motivation

Theory of intrinsic Motivation propogate that intrinsically motivated activities are those for which there is no apparent reward except the activity itself. These activities are ends in themselves and not means to achieve some ends. Though widely accepted this definition could not convince many theorists. Berlyne (1971), for instance, points out that an activity cannot reinforce itself, but rather what it can do is to bring about certain internal consequences which the organism experiences as rewarding.

People engage in many activities which apparently do not yield any external rewards. The rewards for these activities are mediated within the individuals. They engage in the activities not because they lead them to external reward like money, praise, food, etc., but rather because they bring about certain kinds of internal states which they find rewarding.

Recently, Koch (1956, 1961) was one of the first to make strong

assertions that theories of intrinsic motivation should be given considerable importance.

Though Woodworth (1918, 1958) was the first to develop a behavior-primacy theory with which he accounted for intrinsically motivated behaviour, his notion, that an activity, regardless of its initiating motive, could become intrinsically interesting, was given the name 'Functional Autonomy' by Allport (1937).

After Allport many theories of intrinsic motivation were put forward by various authors, for instance, Hebb's (1945, 1946) incongruity theory and Festinger's (1957) cognitive dissonance theory. Hunt (1965) presented a theory which centred around the notion of an optimal level of psychological incongruity. This notion or a similar one, has also appeared in the work of McClelland, Atkinson, Clark and Lowell (1953) and Hebb (1955), etc. Most of the work which has developed from McClelland's theory deals with achievement motivation (McClelland, 1961 ; Atkinson and Feather ; 1966), which is within the category of intrinsic motivation (Horner, 1971).

Hunt (1963, 1965) incorporated the notions of optimal discrepancy into a general theory of intrinsic motivation. He regarded the human as an information processing system and asserted that intrinsic motivation is inherent in information processing and action. In outlining his theory of intrinsic motivation, Hunt (1965) enumerated and provided answers to several critical motivational questions. This assumption is shared almost by all the cognitive perceptual conceptions of personality.

Rogers (1951) also argues for the need to see the world through the client's eyes, for adopting the client's internal frame of reference and for empathic understanding.

White's (1959) concept of competence rejects drive reduction theory and attaches great importance to a person's interaction with his environment. Competence refers to one's ability or capacity to deal effectively with surroundings. This concept encompasses such things as exploration, manipulation, attention, perception, thought and communication, since all these activities are necessary for acting effectively on one's environment. However, concept is a motivational one, that is, white (1959) posits a competence motivation or effectance motivation which is what directs exploration, manipulation, attention,

etc. The behaviours that lead to effective manipulating, for example, are selective, persistent, and directed. They are not random; they are motivated by the intrinsic need to deal effectively with the environment. Effectance motivation causes behaviours which allow a person to have feelings of efficacy. Therefore, he is intrinsically motivated by effectance motivation to engage in behaviours which allow him to feel having competence or efficacy.

Atkinson's Theory

Atkinson (1957, 1964) has specified a mathematical relationship between what he considers to be the various determinants of achievement behaviour. Achievement motivation is a special case of intrinsic motivation, that is, achievement motivation differentiates out of the basic motivational propensity of needing to feel competent and self determining in relation to the environment. Hence with Atkinson's model one can make precise predictions about certain kinds of intrinsically motivated behaviours.

The theory asserts that the tendency to approach (or avoid) an achievement-related situation is the resultant tendency to approach success and to avoid failure. The motive for success (M_s) is simply one's need for achievement, that is, one's need to match some standard of excellence. Probability of success (P_s) is one's expectancy of achieving the goal. As Atkinson (1964) pointed out, this concept derives from Tolman's notion of expectancy of goals.

A person's expectation about reaching a goal through a given behaviour will be based on his experience in similar situations in the past. Probability of success, of course, relates to both a person's ability and the difficulty of the task, so Atkinson's model has considered factors related to the person and to the environment, which is one of Lewin's (1935) basic postulates.

Atkinson's model, while based on the general motivational notions of Lewin (1936, 1938, 1951) and Tolman (1932, 1959), is specific to achievement situations. He emphasizes that many behaviours are motivated at least in part by extrinsic rewards. Therefore, a cognitive model of motivation would include extrinsic as well as intrinsic motivation to be complete.

Deci (1975) has developed a cognitive theory of intrinsic

motivation which is broader than Atkinson's achievement motivation theory.

Deci's Theory :

There are five important elements in Deci's (1975) cognitive model of behaviour :

- (i) stimulus inputs;
- (ii) energy source or motive;
- (iii) establishing of goal;
- (iv) goal directed behaviour; and
- (v) reward and satisfaction.

A Cognitive Model of Behaviour :

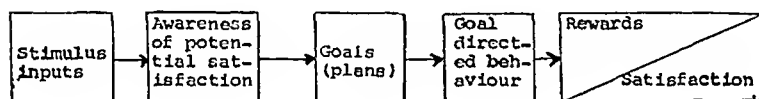


Fig. 2.1

(i) **Stimulus Inputs** : There are three sources of stimulus inputs according to Deci (1975), external stimuli, memory and internal states. It means that the stimulation can either be from external environment, individual's memory or his internal factors such as glandular secretions or affective responses.

(ii) **Awareness of Potential Satisfaction** : Individuals are continuously interacting with their internal and external environments. As mentioned earlier the individual is receiving information all the time and these inputs make the person aware of potential satisfaction. This awareness comes from the information, which in other motivational systems has been labelled as drives, intrinsic motivation and affective states.

(a) **Drives** are important motivators of behaviour. They make the individual aware of the present organic state and about how it could be more satisfied, and the individual uses this information to choose the behaviours which he expects will lead him to more satisfaction.

(b) Intrinsic motivation entails an individual's intrinsic needs for feeling of competence and self determination. This makes him aware of potential satisfaction and he may choose to behave in ways which he believes will lead to certain affective states. This implies that the intrinsically motivated behaviour operates in the same way as extrinsically motivated behaviour. The difference lies in the rewards. For intrinsic needs the reward is the feeling of competence and self determination which has its primary effect in the nervous tissues. The other important difference has to do with the relation of the need. In case of extrinsically motivated behaviour the need is temporarily reduced but in case of intrinsic motivation the goal will be attained and the behaviour will be rewarded, but the need will not be reduced. It is ever present, so it will remain and other goals will be set. This is highly relevant to explain the concept of study involvement as conceptualized in this investigation.

(c) Emotions or affects play an important role in human behaviour. Emotion has been viewed by Arnold (1960) as an organized motivational process. Emotion is defined as an approach or avoidance tendency toward the stimulus input (which is perceived and appraised). Leaper (1948) and Arnold (1960) state that emotions do function as motives. But they serve as both antecedents and consequences of behaviours.

(iii) **Selection of Goal :** The person's evaluation of the various alternative behaviours open to him, on the basis of his expectations of the end states to which the behaviours would lead, is an important element in the cognitive model, Tolman (1932) and Lewin (1935) both talk of goals in their respective theories. Atkinson (1964) in his theory of achievement motivation has dealt in more detail with the evaluation of end states, in predicting achievement oriented behaviour. Different theories have given different relationship between motivation and goal. Atkinson's model, for example, predicts that motivation will be at a maximum when the goal is of moderate difficulty, while Vroom's (1964) model within the realm of industrial motivation shows that motivation is an inverse function of difficulty. As the probability success increases, motivation increases. Therefore, using Vroom's model the prediction will be that motivation will be maximum when the goal is easiest (assuming constant valence).

Locke (1968), on the other hand, mentions that motivation

would be at a maximum when the goals are most difficult. According to him, goals are the most critical factor in motivation.

(iv) **Goal Directed Behaviour** : People select those behaviours which they expect will lead them to desired outcomes (Irwin, 1971). His use of outcomes means rewards. Deci (1975) has put forth an assertion very much similar to Irwin's (1971) in which he states that organisms engage in behaviours which lead to the most valent goals. For Atkinson behaviour is a direct function of tendency to approach (Ta). Vroom (1964) also predicts that people will engage in the behaviours which have the greatest force toward action.

Thus it is clear that people behave to achieve desired goals. This goal directed behaviour according to Simon (1967) may terminate in three ways :

- (a) when the goal has been achieved and satisfaction felt;
- (b) when the individual feels impatient after trying and selects the best alternative and terminates; and
- (c) when the individual tries again and again and fails, he gives up in discouragement.

(v) **Rewards and Satisfaction** : These are the final elements in the cognitive model of motivation. Deci asserts that people seek goals which they expect to bring rewards. The rewards may be :

- (a) extrinsic rewards which relate to drives;
- (b) intrinsic rewards which relate to the need for feeling of competence and self determination; and
- (c) changes in affect which are relatively positive by comparison with the affect which initiated the behaviour.

When a person gets the reward for achieving a goal, he feels satisfied. The satisfaction is the final step in the sequence and will lead to termination of the sequence.

The Theory Underlying The Present Investigation

The theory underlying the present investigation may be labelled as a Cognitive Theory of Intrinsic Motivation.

Cognitive theories, according to Levy (1970), share a basic assumption that a person's behaviour is determined to some extent by his perception and understanding of events. The person is conceived of as an information processing system. Thus, behaviour is

considered not as a direct function of external events but of person's interpretations of those events. External reality is not denied by cognitive theorists, but it is seen as entering into the causation of behaviour primarily through its transformation by the person. This transformation is an important aspect in prediction of behaviour. The approach assumes that the stimulus value of both internal and external events depends upon the meaning given by the individual who is actively engaged in their organization and interpretation. In evaluating the support for theoretical formulations of cognitive organization, Wyer (1974) points out that three classes of variables may affect the reception and the acceptance of information. These are characteristics of the situation in which the information is presented, characteristics of the recipient of the information (individual difference variable) and the characteristics of the information itself.

A cognitive approach to motivation places primary emphasis on a person's thought processes. It assumes that people decide what to do on the basis of their evaluation of the likely outcomes of their behavioural alternatives. Behaviour is the outcome of these decisions. This indicates that cognitive processing is an important determinant of behaviour. This assumption stands in clear contradiction with the assumption of the mechanistic approach which says that thoughts are not causal factors in behaviour (Deci, 1975). Thus cognitive approach to motivation proposes that people make choices about what to do (Taylor, 1960). They act on the basis of their goals and their assessment of various behavioural alternatives which may lead them to these goals. This approach views humans as striving to satisfy their needs by setting goals and choosing behaviours that they believe will help them to achieve these goals. These goals, as Kagan (1972) states, are also cognitive representations. They are, in fact, cognitive expectations about future states.

The conceptual model of involvement as seen in the present investigation is developed after Deci's theory (1975) of intrinsic motivation. The important elements of Deci's theory (1975) as justified in the context of the present investigation are explained below :

Behaviour is the resultant of stimulus inputs, which have three sources according to Deci (1975). Internal states are one of these stimulus inputs. In the present investigation the needs as selected for the study serve as stimuli. The nonfulfilment of these needs gives rise to an awareness of potential satisfaction making individual aware that

the fulfilment of these needs will reduce the tension and consequently bring satisfaction. Traditionally, in experimental psychology, the 'energy' for behaviour has been derived from basic drives such as hunger, thirst, and sex, and secondary drives which develop out of pairing with primary drives or social needs. All these processes act as cues which provide information to the central information processing system to the effect that satisfaction can be experienced.

The person, then, establishes a goal from among the set of alternatives which he feels are open to him. At the time of choosing the goal, the individual keeps in mind his awareness of potential satisfaction and his expectation about achieving that satisfaction. Besides his attitudes, feelings, and other internal states also provide information which are used in the decision making. In the study involved behaviour the attempt to reach a defined goal and the consequent satisfaction reinforces the establishing of a goal. Goal setting for the individual is an important activity and the level of motivation is positively related to the difficulty level of goal (Atkinson, 1957, 1964, Locke, 1968) perceived by the individual.

Once the individual has chosen a goal, he will behave in such a manner as to achieve that goal. Irwin (1971) has emphasized that individuals try to achieve those goals which they expect to bring rewards. These rewards may be (i) extrinsic or (ii) intrinsic. In the case of study involved behaviour both these types of rewards are attained, for example, getting good grades (marks) in the examination is an extrinsic reward, whereas, satisfaction of various needs is an intrinsic reward, which the individual gets through goal directed behaviour.

Conceptually satisfaction follows the reward. When a person is rewarded for achieving a goal, he will feel satisfied. In fact, in the case of intrinsic or affective rewards, it is difficult to separate the positive affect which is the reward from the perception of satisfaction. The satisfaction is the final step in the sequence of the five elements of Deci's theory (1975), such as stimulus inputs, awareness of potential satisfaction or motive to behave, goals, goal directed behaviour, and rewards and satisfaction, and will lead to termination of the sequence of behaviour which gives rise to new goal directed behaviour, leading to further satisfaction and achievement,

CHAPTER 3

REVIEW OF LITERATURE

The present chapter is concerned with the various factors related to student involvement in studies and a numbering hypotheses developed in the investigation.

Factors Related to Student Involvement in Studies

An extensive review of research showed that no work has ever been done in the area of student involvement in studies per se, but it was revealed that work has been done in the broad area of intrinsic motivation. Involvement in studies is a specific kind of intrinsic motivation in academic situations. It was, therefore, thought feasible to review the research done in intrinsic motivation and to find out what factors may possibly be related to the academic motivation.

Background Variables :

1. **Sex**—The shift in emphasis in the recent years regarding the possible entry of women in every occupation at various levels of the prestige hierarchy ranking has affected the thinking of the school students considerably. In a study conducted by Chaudhary (1971) it was revealed that n—Achievement was higher in girls as compared to boys. Similar findings were obtained by Gokulnathan (1972) on secondary school tribals of Assam, Mubayi (1974) on secondary school tribal pupils of Gujarat, and Parikh (1978) on classes VIII, IX, and X students of Bombay schools. However, the findings of Sinha (1967) and Desai (1970) indicated the boys as having higher n-Achievement. Spence (1974) reported a growing tendency for males to downgrade achievement. House (1974) found that when females were in competitive situation, they showed lower expectancies for their performances than did males.

These investigations indicate that there might be some relationship between sex and academic motivation. Hence, it was decided to include sex as a variable in this study.

2. **Birth-order**—Although Adler (1945) suggested the importance of an individual's ordinal position in the family, until recently very little research has been done using ordinal position as an independent variable. A few years ago Schachter (1959) published a book in which he reported the interesting results of a series of studies on ordinal position, motivation, and behaviour in social or experimental situations.

The difference in affiliative behaviour between first and later borns is generally given a motivational interpretation. Because of the differences in parental treatment of first and later borns, the former acquire higher affiliative or/and dependency needs than the latter. The motivational differences are then translated into differences in behavioural tendencies under appropriate arousal conditions (Dember, 1964).

McClelland, et al (1953), Atkinson and Miller (1956), Rosen (1961), and Sampson (1962) found that the first born had a higher motivation for achievement than the later born as they received greater parental care, particularly from the mothers, as they had less work on their hands, whereas Schachter (1959) found that they were characterized by dependency. Mukherjee (1968), however, found equivocal evidence on this. Karabenick (1971) found no particular relationship between subjects' birthorder and their need for achievement.

There does not, however, seem to be any conclusive evidence on the relationship between birthorder and motivation. For this reason, birthorder as an independent variable has been included in the present investigation.

3. **Caste**—Caste has not been studied as an independent variable in any investigation related to motivation so far. Chopra (1964) studied relationship between various castes and academic achievement and found that the difference between the academic achievement of different castes was significant at .05 level. In the present study scheduled caste and non-scheduled caste students were studied vis-a-vis involvement in studies. It was thought feasible to study students from these two sections of society in view of the fact that in the Indian society the opportunities available for education and values, beliefs and attitudes etc., held by these sections are considerably different from each other. Chitra (1969) studied the educational opportunities for

women in two Mysore Colleges and found that the cliques in the untouchables and Muslims influenced their behaviour as well as attitudes which were different from upper caste students. Chitra's (1969) study reveals that caste is a dominant role offering Brahmins better facilities for educational training.

4. Management of School : There are generally four types of schools operating in Delhi where this study was conducted. These school types are : (i) Government Schools ; (ii) Private aided Schools ; (iii) Public (private) Schools ; and (iv) Central Schools.

The general atmosphere in these schools differs considerably. Gaur (1973) in his study found that there was a significant difference between the levels of occupational aspirations of the higher secondary school students in the three types of schools such as (i) Public (ii) Private aided and (iii) Government. Since this variable has not been studied in the context of academic motivation, it was deemed desirable to study it in this investigation.

5. Type of School (sexwise) : In Delhi three types of schools exist : (i) schools exclusively for boys : (ii) schools exclusively for girls ; and (iii) coeducational schools.

It is quite obvious that the group dynamics in these schools will differ considerably. Arguments have been advanced favouring both kinds of systems. Single sex schools are said to involve a simpler curriculum, fewer disciplinary problems and a greater concentration on academia rather than frivolity (Biddle, 1970). A review of studies revealed that this variable has been studied in a very few investigations at the school and college levels. Gupta (1977) in a study conducted at the college level concluded that boys in coeducational colleges are more emotionally stable and have more achievement need, whereas girls have more leadership qualities like authority over others.

Sinha (1975) found that most of the girls in Allahabad schools are confident about their achievement. Girls from exclusively girls' schools are slightly more confident. Mitra, et al (1975) also studied some of the effects of coeducation on perception of women's status at school and college levels. They found that coeducation at school and college levels tends to increase the perception of traditional belief regarding women's role.

6. **Geographical Location :** There have been very few investigations which have taken the geographical location of the school in consideration. Mehta (1969) concluded that the rural and urban high school boys showed no difference in their n-Achievement levels. In another investigation conducted by Mehta, Kumar, Sharma and Kanade (1967), the same findings were obtained. A study on tribals of Assam, conducted by Gokulnathan and Mehta (1972), indicated that the area of residence which was in most cases the same as the location of the school, had no bearing on the level of n-Achievement of the pupils.

In a study by Jagbir Kaur (1972), class X pupils from schools of urban and rural areas were selected. No significant difference was found in motivation level between urban and rural students. Results of the study by Munz, Sinouse and Letchworth (1968) are in keeping with the findings of Jagbir Kaur.

Query and Query (1973) also studied the effect of geographical background on need affiliation and school activity participation. They collected data on male high school students and found that rural-urban effect was apparent in later born children and not among first borns.

7. **Socio-economic Status :** Various studies have been conducted to find out the relationship between the socio-economic status of the family and students' academic motivation. Entwistle (1968) constructed a 24 item self rating inventory to assess academic motivation and compared inventory scores with teachers ratings to give evidence of concurrent validity. His study revealed that academic motivation was not closely related to social class. Barial's (1966) study was undertaken to investigate the extent to which the social class background influenced the educational achievement and motivation. This investigation also revealed that there was no difference in the educational achievement and achievement motivation of students belonging to various social classes. On the contrary Hayes (1969) studied the influences of the environmental factors (particularly the socio-economic status) on child's motivation for learning and found that these two were related. Desai (1971) also found the same results.

Chaudhary (1971) found that the correlation between n-Achievement and social class scores was positive and significant for

the total group of 409 boys and girls of higher secondary schools, but it was not significant in the case of boys as well as girls (when computed separately).

Parikh (1978) also found similar results in a study undertaken by her in Bombay on a sample of class VIII, IX, and X students.

Mehta's (1969) study of 975 class IX boys of Delhi showed that those in schools with low SES and low achieving status had n-Achievement level equal to that shown by boys studying in schools with high SES and high achievement status, but was higher than those studying in middle SES and high achievement status schools.

Mehta, et al (1967) also found that the school SES was significantly related to the pupil's n-Achievement levels.

Tamhankar (1968) found that boys from middle class families had higher achievement motivational level than those of upper and lower classes.

Stavros (1972) studied relationship between socio-economic status among a sample of students with their educational aspirations and educational expectations and found that there was a positive, statistically significant relationship between socio-economic status and each of the two dependent variables, namely, educational aspirations and educational expectations for both males and females.

Sewell and Shah (1968) found that parents' encouragement appeared to have its strongest effect on the college plans of males and females who scored relatively high on intelligence and came from families occupying relatively high socio-economic positions.

Seidel (1970) selected 81 pairs of students matched for sex and class attainment from 10th, 11th and 12th grades of a high school attended by residents of two neighbouring but culturally and economically divergent communities. On analysis it was found that subjects from the more prosperous town showed significantly higher educational and vocational aspirations and optimism.

Psychological Variables :

1. **Personality Characteristics :** Relationship between the various personality characteristics and academic motivation has been studied in various researches.

De and Jha's (1978) findings revealed that there was a relationship between certain dimensions of personality, achievement motivation and intelligence.

Newman Jr. (1972) proposed in his thesis the theoretical possibility that there is a self control-social control (intrinsic-extrinsic) continuum in personality that affects individual motivation and performance. A process model of motivation was employed (Porter & Lawler 1968, and Lawler 1970). The measures of the two self motivational factors were found to be correlated significantly with the measures of subjective efforts. Query and Query (1973) found a positive relationship between need affiliation and school activities.

Tuel and Wurston (1965) studied the influence of intrapersonal variables on academic achievement and academic motivation. Middleton and Guthrie (1959) analyzed drive related to high and low achievement. High achievement may be motivated by drives for power, resentment, dependence, social acceptance and aggression. Low achievement may be motivated by drives toward pleasure seeking, extroversion, denial of normal shortcoming and power.

Gordon (1968) found the various personality factors, namely, ascendancy, responsibility, emotional stability, sociability, cautiousness, original thinking, personal relations, vigour, practical mindedness, achievement, variety, conformity, decisiveness, orderliness and goal orientation as relatively independent and which were important in determining the adjustment of the individual in social, educational and industrial situations.

Lynn (1959, 1960) found that capacity for sustained work depended largely upon an individual's level of drive and rate of accumulation of reactive inhibition.

Evan's (1972) study was designed to determine the relationship between personality needs and students' satisfaction with respect to selected dimensions of the college campus. The results indicated that a significant relationship did exist between personality needs and satisfaction with respect to selected dimensions of the campus environment.

McKeel Jr. (1968) conducted a study to determine, if significant relationships existed between the academic performance of engineering

students and certain personality and environmental variables. The predictor variables were :

- (i) personality needs as measured by Stern's Activities Index ;
- (ii) environmental press as measured by the College Characteristic Index ; and
- (iii) need—press difference scores.

It was concluded that significant relationships existed between academic performance of engineering students and a number of scales of the Activities Index and College Characteristics Index.

Sinha (1970) found that the academic attainment of a student depended upon many intellectual factors in which effort, in the shape of drive or motivation was an important factor.

Uhlinger and Stephens (1960) found that need for achievement did not differ from high and low achievers except that high achievers showed greater need for social love and affection and had generally higher minimal grade goals and greater expectancy for academic success.

Some studies have come out on personality in relation to achievement motivation. The studies in this area have been conducted by Pareek (1967). De and Khan (1960), and Siddiqi and Akhtar (1969).

Aaroon (1968) studied the relationship between n-Achievement n-Affiliation, n-Power and tasks connected with teaching.

Bowman (1972) and Smart, Elton and Burnett (1970) reported that academic performance was significantly related to different personality characteristics and behaviour such as self perceptions, motivational drives, etc.

Goldstein and Heilburn Jr. 's (1962) study offers some support for the notion that personality factors are significantly related to academic achievement when the influence of academic ability is statistically removed. The findings of the study support the view that personality factors are most important in determining the academic motivation and achievement of average ability college males.

In this group of average ability males, intellectual factors are less predictive of success and personality factors are the more important determinants of actual academic success and failure.

Barial (1966) also found that intelligence was negligibly correlated to academic motivation ($r = -.02$). Chaudhary (1971) also concluded that the correlations between the academic motivation and intelligence scores for the combined samples and for boys were not significant, whereas the same was significant at .01 level for girls.

Desai (1971), on the other hand, found a definite positive correlation between IQ and n—Achievement scores. French (1957) had also studied the joint effects of intelligence and achievement motivation on problem solving success of airmen and found a significant interaction between these two variables.

Wolf (1968) proposes a theory of motivation in the occupational set up based on Maslow's (1943) hierarchy of needs. He theorizes that job motivation results from an individual's perception of the relationship between gratifying consequences.

2. Level of Aspiration: Two people may possess the same absolute level of ability, yet one may set his standard very high, while the other may be content to aim at nothing higher than a maintenance of status. Thus in choosing life goals and while doing daily activities, people widely differ in their expectations and aspirations. As a concept in Psychology, level of aspiration was not very much recognized until 1935 when the construct was translated into English as level of aspiration by Hoppe (1931) and Dembo (1931). Further studies were conducted by Rotter (1942), Lewin, et al (1944), Gauld and Kaplan (1940), etc. Hoppe (1931) conceived level of aspiration as a technique for studying dynamic psychological factors which operate in the prediction of feelings of success and failure. Frank (1935) views that level of aspiration is a stable personality characteristic relatively independent of specific task.

Muthayya and Rajeshwari (1969) studied personal aspiration and its relationship with achievement motivation in female secondary grade trainees. A pictorial non-verbal ladder scale was used as a

Pareek, Kumar and Chattopadhyaya (1967) studied families in a north Indian village and factor analyzed the data concerning level of aspiration on seven different aspects of living and traced three factors of which achievement orientation explained 22 percent of the variance. Jawa (1972) found a significantly positive correlation to future aspirations.

It may thus be concluded that researches have identified level of aspiration to correlate significantly with intrinsic motivation.

3. Social Desirability. The shift in emphasis from form to content and style in the assessment of personality has generated considerable research in recent years. A response set irrespective of the content of the personality measure seems to account for much of the variance and may in itself be an important measure of personality. Cronbach (1946) defines a response set as,

“any tendency causing a person consistently to give different responses to test items than he would when the same content is presented in a different form” (p. 476).

Based on this concept of response set researchers have done a great deal of work with particular reference to the response tendencies to agree and to respond desirably.

Edwards (1957) has defined the variable of social desirability as the tendency of the subject to answer ‘Yes’, ‘True’, or ‘Agree’ to statements having consensually defined social desirability, and to answer ‘No’, ‘False’, or ‘Disagree’ to statements having consensually defined social undesirability.

Edwards (1957) further states,

“.....that there is sufficient evidence to indicate that the tendency to give socially desirable responses in self-

description is a fairly stable personality characteristic. Thus a subject who shows this tendency to a high degree on one personality inventory will also show it to a marked degree in his responses to items in other personality inventories."

An extensive survey of researches revealed that this variable had never been studied as an independent variable along with academic motivation. Hence, was deemed feasible to study in this investigation.

4. **Characteristics Preferred by Parents :** Parental permissiveness and authority play an important role in the personality development of the child. Baumarind (1971a and 1971b) has provided some insights on this line. Harmonious parents seem neither to exercise control nor to avoid the exercise of control. Instead, they focus upon achieving a quality of harmony in the home and upon developing principles for resolving differences and for right living.

Sherif and Cantril (1947) and Sherif and Sherif (1967) have pointed out that the parents communicate directly their beliefs, attitudes, and standards to the child. The parent reinforces what he deems to be desired behaviour in the child. We should assume that broad and general parental training is a determining factor in the child's response to a particular situation.

A study done by De and Shambhoo Priya (1972) showed that the students whose parents were highly educated had high achievement motive than those students whose parents were low educated.

It has been found that high need achievement of mothers motivate their children (Rosen and D'Andrade, 1959, McClelland, 1961, and Duncan, Featherman and Duncan, 1972).

Babladelis and Adams (1967) found that the shaping of any particular motive as dominant in an individual's behaviour depended upon rather specific repeated behaviours on the part of the parents towards the child. As an example, for those children who have high achievement motivation, we find that parents consistently respond positively to many behaviours that have in common independence, purposefulness, and concrete results, (such as solving problems). Activities not bearing the label of 'important' are simply experienced

as less satisfying by the child. It is important to note that it is parental response to some aspects of behaviour.....its intellectual or affiliative or independent component that establishes for the child an equivalence among what are superficial different behaviours.

Further empirical studies have supported that the child's need for achievement is influenced by rearing process. For example, Winterbottom (1958) has demonstrated a relationship between need for achievement in 8 to 10 year old boys and the attitudes of their mothers. Rosen (1959) found the same results in samples of children from various groups.

McClelland and Friedman (1952) reported a relationship in various Indian tribes between need for achievement and the childhood training for independence.

The evidence, then, is quite clear that the achievement motive begins to differentiate during childhood, that the motive of adults is correlated with the motive which they displayed as six year olds (Moss and Kagan, 1961) and parental attitudes and behaviours affect the development of the achievement motive.

All these evidence suggest the importance of behaviour, preferred and expected by parents.

5. Scholastic Achievement : Sutton (1961) studied children in three fifth grades through individual school histories, self reports, descriptive ratings by peers and teachers, observations of current behaviours and personality inventories. It was concluded that a child's poor performance may be due to lack of basic ability or to lack of motivation and of positive emotional involvement.

Singh (1965) used two measures of motivation, the n-Achievement scale of Edward's Personality Preference Schedule (EPPS) and an unstandardized measure of academic motivation, and on both the measures he found motivation to be positively related to the academic achievement of college students.

Lowell (1952) showed that subjects who scored high on n-Achievement had a higher level of performance than subjects who scored low on n-Achievement on an arithmetic and on a verbal task.

Mehta (1969) found that n-Achievement showed positive correlation with the total performance at the schools annual examinations. Tamhankar (1968) also found a low positive correlation between the two.

Russell (1969) observed that teachers were quick to agree that school motivation was evident in class room behaviour, but they tended to describe it in terms such as enthusiasm, involvement, attentiveness and joy, etc.

Eugene (1976) tried to study the relationship between student involvement and student achievement and found that there was no significant positive relationship between the two.

Bassett and Campbell (1964) emphasize that we educators should know considerably more about how motives arise and how they are directed and stimulated. When we know as much about children's motivation for school work as we do about their aptitude for it, our educational theory will be greatly advanced.

Thresher (1959) pointed out that students who were poor achievers and drop out, either through formal disqualifications or of other reasons, did not lack in intellectual ability, nor did most of them lack adequate preparation. Their trouble stemmed in poor motivation.

Bhatnagar (1976) in a study to see the efficacy of individual counselling on the achievement of bright underachievers found that bright underachievers had a poor academic drive. Pal and Saxena (1970) had also stated that underachievement was due to lack of motivation.

Varma (1966) in his investigation found that students expressing high degree of ego involvement and good study habits had comparatively secured better marks in their final examination. The ego involvement indicated the degree of persistence. Obviously, students having a high level of ego involvement tried to secure better points.

Srivastava (1967) also pointed out that under-achievement was related to poor study habits and low academic motivation and Lum (1960) reported that overachievers tended to have greater motivation for studies.

In some of the studies personality characteristics do not show any relationship with academic achievement. Demos and Spolyar (1962) found no significant differences between four groups in terms of achievement on EPPS, and they concluded that the various achievement groups could not be distinguished in terms of personality needs.

Shaw (1961) administered the McClelland Achievement-Motivation Test, the French Need Achievement Scale and the EPPS to underachievers and achievers. None of the three differentiated achievers from underachievers with the exception of the French Scale, which did differentiate between achievers and non-achievers.

Barial's (1966) investigation on the contrary revealed that scholastic achievement had almost zero correlation with achievement motivation ($r=0.08$).

Sinha (1965) also found that the high and low achievers did not differ in their achievement motivation, though in the eyes of the faculty high achievers were much superior on cognitive intellectual qualities and showed greater motivation.

Hass (1963) found that the difference between the superior and average students was not significant in terms of personality. The difference was in terms of ability and diligence.

At this point it almost goes without saying that a great deal more research is required on the relationship between achievement imagery (satisfaction of needs, that is involvement in studies) and achievement in school.

Development Of Hypotheses

According to studies related to motivation as given in Part I of this chapter and theories of motivation and behaviour as given in chapter II, variables studied in this investigation are presumed to be related to student involvement in studies.

The hypotheses formulated for testing in this investigation are as given below :

Hypothesis I : is related to certain background variables, such as,

- (i) Sex
- (ii) Birthorder
- (iii) Management of school
- (iv) Type of school
- (v) Geographical location and
- (vi) Socio-economic status.

It is hypothesized that :

- (a) certain background variables like sex, birthorder, caste, management of school, type of school, geographical location of school and socio-economic status of students are related to involvement in studies.
- (b) Students in high and low involvement groups differ as regards to these background variables.

Hypothesis II : is related to certain psychological variables, namely,

- (i) Level of aspiration
 - (ii) Social desirability
 - (iii) Characteristics preferred by parents and fourteen personality factors as measured by High School Personality Questionnaire by Cattell (1958) which are as under :
- (i) Sociability
 - (ii) Intelligence
 - (iii) Ego-strength
 - (iv) Excitability
 - (v) Dominance
 - (vi) Surgency
 - (vii) Super-ego strength
 - (viii) Adventurousness
 - (ix) Sensitivity
 - (x) Passive individualism
 - (xi) Guilt proneness
 - (xii) Self sufficiency
 - (xiii) Self control and

(xiv) Ergic tension.

It is hypothesized that :

- (a) Level of aspiration is related to involvement in studies.
- (b) Social desirability is related to involvement in studies.
- (c) Characteristics preferred by parents are related to involvement in studies.
- (d) Fourteen personality factors like sociability, ego strength excitability, etc., measured by HSPQ are related to involvement in studies.
- (e) High and low involvement groups differ as regards to these psychological variables.

Hypothesis III. is concerned with students' scholastic achievement at classes IX and X. School subjects taken into consideration at both these levels are :

- (i) English
- (ii) Mathematics
- (iii) Hindi
- (iv) Social Studies
- (v) General Studies
- (vi) Total marks.

It is hypothesized that :

- (a) Student's achievement in school subjects is related to involvement in studies.
- (b) Student's showing high and low involvement in studies differ as regards to their scholastic achievement.

Hypothesis IV : (a) Intelligence of a student is related to the level of involvement in studies.

(b) High and low involvement students will show a significant achievement difference in their intelligence.

Hypothesis V : (a) Background, psychological and scholastic variables will predict student involvement in studies.

(b) High and low involvement groups will differ as regards to certain background, psychological and scholastic achievement variables in a multivariate combination.

Hypothesis VI : High and low involvement groups differ as regards to satisfaction of ten need areas, namely, n-Abasement, n-Achievement, n-Affiliation, n-Aggression, n-Autonomy, n-Deference, n-Nurturance, n-Order, n-Recognition, and n-Succorance.

CHAPTER 4

METHODOLOGY

Tools-Tests and Scales

To test the hypotheses put forward in the previous chapter, seven tests, inventories, and questionnaires were used to collect data on various variables included in the study. The detailed description of each of these instruments is given in the following paragraphs :

1. Culture-Fair Intelligence Scale III Form B : (Indian Adaptation by Singh & Rao.) 1964.

Since the sample for the study consisted of boys, girls, rural and urban pupils from Government, private-aided, Public (private), and Central Schools, an appropriate test having no cultural bias was selected for measuring intelligence.

In the varied research situations, in which general ability is one of the variables, modern psychology has a test which can clearly separate the individual's real general ability from the accidental circumstances of better or poorer local schooling, social class, etc. Such factors are likely to introduce a substantial error into assessment made by conventional intelligence tests.

The Culture-Fair Intelligence Scale 3, Form B originally prepared by Cattell and Cattell (1961) and as adapted for India by Singh and Rao (1964) was administered as a group test. The test consists of geometrical figures like series, classifications, metrics, and topologies. There are 50 items. The total time required to administer this test was about 20 minutes.

Reliability : Test-retest reliability of the test as reported in the manual is .82 (N=200) and .85 (N=450) for immediate test-retest

sessions on two samples. The Split-half reliability coefficients are between 0.70 and 0.92

Validity : The test shows a correlation of 0.56 with the Stanford Binet Test, a correlation of 0.73 with the Otis and a correlation of 0.84 with Wechsler Bellevue.

2. Jr. Sr. High School Personality Questionnaire (HSPQ) (Indian Adaptation by Kapoor & Mehrotra) 1967

It is an objectively scoreable test, devised by Cattell (1958) to measure fourteen dimensions or traits of personality which have been found by psychologists to come near to covering the total personality. These dimensions are functionally independent and psychologically meaningful. The test is available in two forms—'A' and 'B.' In the present investigation 'HSPQ Form 'B' adapted in Hindi by Kapoor and Mehrotra (1967) has been used. According to the authors the canons of good test construction have been followed in the design of this test. It is a test of 140 items, carrying 10 items for each of the 14 factors.

The personality dimensions measured by HSPQ have two poles or extremes, which are given in the following table :

Table : 4 : 1

Brief Description of the Fourteen HSPQ Personality Factors (Cattell, 1963)*

Low Sten Score Description	Alphabetic Designation of Factors	High Sten Score Description
A boy or girl with low score is :		A boy or girl with high score is :
RESERVED, Detached, Critical, Cool	A	OUTGOING, Warmhearted, Easygoing, Participating.
LESS INTELLIGENT, Concrete thinking,	B	MORE INTELLIGENT, Abstract thinking,

38 *Predictors of Student Involvement in Studies*

of low scholastic mental capacity		Bright, of higher scholastic mental capacity.
AFFECTED BY FEELINGS C Emotionally less stable, Easily upset, Changeable, of lower ego strength		EMOTIONALLY STABLE, Faces reality, Calm, of higher ego strength.
PHLEGMATIC, Deliberate, D Inactive, Stodgy		EXCITABLE, Impatient, Demanding. Overactive.
OBEDIENT, Mild, E Conforming, Submissive		ASSERTIVE, Independent, Aggressive, Stubborn, Dominant.
SOBER, Prudent, F Serious, Taciturn		HAPPY-GO-LUCKY, Gay, Enthusiastic, Impulsive, Lively.
EXPEDIENT, Evades rules, G Feels few obligations, Has weaker super-ego strength		CONSCIENTIOUS, Persevering, Rule-bound, Has stronger super-ego strength.
SHY, Restrained, H Diffident, Timid		VENTURESOME, Socially bold, Uninhibited, Spontaneous.
TOUGH MINDED, Self I reliant, Realistic, no-nonsense		TENDERMINDED, Dependent, Over protected, Sensitive.
VIGOROUS, Goes J readily with group, zestful, Given to action		DOUBTING, Obstructive, Individualistic, Reflective, Internally restrained, Unwilling to act.
PLACID, Confident, O Serene, Untroubled		APPREHENSIVE, Worrying, Depressive, Troubled, Guilt prone.

GROUP DEPENDENT, A 'Joiner' and Sound Follower	Q2	SELF SUFFICIENT, Prefers own decisions, Resourceful.
INDISCIPLINED, Self conflict, Careless of protocol, Follows own urges, Has low integration	Q3	CONTROLLED, Socially precise, Self disciplined, Compulsive, Has high self concept control.
RELAXED, Tranquil, Turpid, Unfrustrated	Q4	TENSE, Driven, Over- wrought, Frustrated.

*—For source please refer to 'References'.

However, in this questionnaire, high scores are not necessarily 'good' and low scores 'bad'. This may be true of abilities, but in personality each type of temperament usually has both good and bad points, for example, in dimension 'A' the high scoring warm-hearted person is rated as good, natural, attentive to people, and trustful, but his easy goingness means that his promises do not always mean as much as those of person at the low score pole on Factor 'A'. The latter is precise and dependable in his work but his aloofness and stiffness is not so attractive socially.

Reliability : From a population of 100 school students Kapoor and Mehrotra (1967) have estimated three types of reliability :

- (i) Coefficient of Stability (test-retest) ;
- (ii) Coefficient of Consistency (or Homogeneity or Split half) ;
and
- (iii) Coefficient of Equivalence (Parallel forms).

Validity : Construct validity has been estimated by Kapoor and Mehrotra (1967) as square root of coefficient of equivalence. Reliability and Validity Coefficients reported in the HSPQ Manual (1967) vary from moderate to high.

The scores of the fourteen HSPQ dimensions were treated separately in the present investigation as they have been claimed to be independent of each other by Cattell. This test is administered without a time limit but can be completed by even the slowest readers

in about 40–50 minutes. Scoring of the answer sheets was done as per instructions given in the manual with the help of hand stencil keys.

3. Edwards : Social Desirability Scale (1957)

The scale used in this investigation to measure social desirability is called the Socialization Scale and was constructed by Edwards (1957). The scale contains 39 items in all. Originally there were 150 items from the anxiety, L. F. and K—Scales of MMPI. Ten judges were asked to give socially desirable responses to the items selected from L. F. and K Scales of the MMPI.

Edwards (1957) found 79 items to which a particular response 'Yes', or 'No' was judged as the socially desirable response. Then these 79 items were analyzed and a set of 39 items selected. These items according to Edwards (1957).

“.....showed the greatest differentiation between a high and a low group in terms of total social desirability scores on the 79 items scale” (p. 30).

In the questionnaire used in the present investigation, items from 1 to 30 have been keyed 'false' and from 31 to 39 have been keyed 'true'. This provides a measure of the tendency of subjects to give socially desirable responses to statements of self description. Therefore, the socially desirable score obtained from the responses to this scale is based upon the number of socially desirable responses a subject gives in self description.

4. Misra : Characteristics Preferred by Parents (CPP) (1964)

A questionnaire containing 17 pairs of statements was constructed by Mishra (1964). Two different characteristics of high school students are listed in each pair of statements. The individual respondent is asked to check which of the two characteristics given in each pair of statements is preferred by his parents. Care was taken to present the two characteristics in dichotomous way, one relating to free and spontaneous behaviour and the other relating to restrictive conforming behaviour which is socially reinforced.

The behavioural, affective and evaluative components of the free

and spontaneous behaviour have been mainly derived from Gibson's concept of sensitivity. Gibson's work (1963) emphasizes the role of free transactions between the organism and the environment in obtaining information from the available stimulation. An attempt has been made in the present questionnaire to relate free and spontaneous behaviour to the abstract conceptualizing characteristics. Furthermore, some of Gibson's observations on the 'active touch' (1962) have been made use of in the present questionnaire with particular reference to the self-generated motivation. Gibson (1962) indicates that behaviour initiated by the organism helps in obtaining information from the stimulus. In line with Gibson's findings an attempt was made to select spontaneously categorized items for the present questionnaire which reflect 'initiating' characteristics of behaviour.

5. Shah and Bhargava : Level of Aspiration Measure (1972)

The test sheet of level of aspiration has fifty circles (each of 1C.M. in diameter) arranged in five rows. On the above and below of these five rows of 50 circles, there are two boxes on the right side. The upper box is for writing the number of expected scores (ES) or aspired performance whereas the lower box is for putting the number of completed performance or actual score (AS). The test provides three types of scores :

- (i) Goal discrepancy score ;
- (ii) Attainment discrepancy score ; and
- (iii) Number of times the goal reaches score.

The test can be administered individually as well as in group. The subjects have to draw four lines in each circle so that it may look like a human face. The faces should be constructed in an order. The subjects were given instructions as given on the first page of the booklet. For each trial thirty seconds were allotted for the work. The discrepancy score between the expected score and the actual score was found out.

Reliability : The test-retest reliability with a time gap of one month was found to be $+0.84$ ($N=50$).

Validity : The index of validity is not known. The authors

claim that the question of validity is not relevant to the study of level of aspiration.

Norms. The test was standardized on a sample of 600 higher secondary and college level students and percentile norms were calculated.

6. Bhatnagar : Study Involvement Inventory (1982)

The inventory contains 40 items in a likert type format with three point response scale namely 'Yes', 'Undecided' and 'No'. It also has two filler items. These forty items cover ten need areas (Murray, 1938) viz. (i) Abasement (ii) Achievement (iii) Affiliation (iv) Aggression (v) Autonomy (vi) Deference (vii) Nurturance (viii) Order (ix) Recognition (x) Succorance.

All statements are scored as 2, 1 and 0. However, item Nos. 13 and 37 are scored in a reverse order. The total score of a respondent is obtained by adding the scores on all the individual statements. The possible maximum score is 80.

The inventory is self administering type and can also be used in groups. There is no fixed time limit to answer the inventory, but an average student takes about 10-15 minutes to complete it. After distributing the booklets students are asked to read the instructions silently given on the cover page while the tester reads them aloud.

Reliability : The test-retest reliability with a time gap of one month is found to be .87 ($N=150$). The split-half reliability applying the Spearman-Brown formula has been found to be .67 ($N=150$) with an index of reliability of .70.

Validity : Inventory has a high content and construct validity as expressed by 33 experts of Psychology. The researcher expects that other types of validity will be established in due course, when the inventory is used more and more by research and guidance workers.

Norms—The inventory has been standardized on a sample of 600 students (boys and girls of class X of Delhi Schools) and percentile norms have been prepared to interpret the students' involvement in studies.

7. Jalota etc. : Socio-economic Status Scale (1970)

Socio-economic status is an important social variable and hence the need for the study of socio-economic background of the individual. The appraisal of socio-economic stratum is of immense importance in any psychological study because one's position in the social hierarchy is correlated with attitudes, values, school achievement, emotional stability, and many other phenomena (Gough, 1948, Gordon 1952, and Kohn 1959).

In order to measure the socio-economic status of the student the Socio-economic Status Scale prepared by Jalota, Pandey, Kapoor, and Singh (1970) was used. The authors recommend this as an usable tool for urban as well as rural groups. Unlike the Kuppuswamy's (1962) and Pareek and Trivedi's (1963) questionnaires which are commonly used either for the urban or for the rural populations, this questionnaire has an advantage of being usable for both rural and urban populations.

The instrument contains 12 items covering such areas as parental occupation, father's/guardian's education, monthly income, house type, household material possessions, cultural sub-factors, education of individual's siblings, level of aspiration, concept of social prestige and belief in caste. Directions for administering and scoring were followed as given in its manual.

Reliability : Test-retest reliability of the scale is reported in the manual to be .89 ($N=50$) after one month interval.

Validity—The concurrent validity of the scale has been established after testing the identifiable groups.

8. Background Information

Six background variables (besides SES) were included in this study. Information regarding these, namely, sex, birth-order, caste of student, management of school, type of school, and geographical location was compiled from the students as well as administrative records. These background variables were in discrete categories, which have been given in table 4 : 2.

Table 4 : 2
Information regarding Background
Variables included in the Study

Variables	Levels	Description
Sex	Two	1 Girls 2 Boys
Birth-order	Three	1 First born and the only child 2 Middle born and 3 Last born
Caste	Two	1 Scheduled caste 2 Non Scheduled caste
Management of school	Four	1 Government School 2 Private aided School 3 Public (private) School and 4 Central School
Type of school (sex-wise)	Three	1 Girls' School 2 Boys' School and 3 Co-educational School
Geographical location of school	Two	1 Urban 2 Rural

9. Scholastic Achievement :

Examination marks of all the students were collected from school records. Subjects taken into consideration at IX and X class levels are English, Mathematics, Hindi, Social Studies, General Science and Total Marks.

Sample

The sample for the study was selected in two stages. The selection of schools was made in the first instance and then students were selected from the selected schools.

1. Selection of Schools :

The study was conducted in Government Higher Secondary Schools, Private aided Schools, Public (private) Schools, and Central Schools. These are the four types of schools which exist in Delhi. The selection of the schools was made according to the quota sampling technique (Kish, 1965) on the basis of the latest list of schools in Delhi supplied by the Directorate of Education, Delhi Administration.

2. Selection of Students :

The population taken into consideration for the purpose of this study consisted of students of class X from 15 schools selected according to the above criterion. For the purpose of drawing a random sample, a serial number was given to the students of each section of class X of each school. About 40 students from all sections of each of the 15 schools were selected on the basis of the table of random numbers prepared by the Bureau of Transport Economics and Statistics of the Interstate Commerce Commission, Washington D.C. This was done in order to apply large sample techniques. In this manner 600 students were selected for the study out of these 238 were girls and 362 were boys.

Procedure

For the purpose of collecting data rapport was established with the students by giving self introduction and the purpose and objectives of the study in brief. The data were collected by administering the test in a group situation in two sessions of two hours each. Achievement data were collected from school records. Information regarding name, sex, birth-order, caste and type of school was also gathered for all the students.

Complete data were thus obtained on the following variables.

Background Variables :

- (i) Sex
- (ii) Birth-order
- (iii) Caste
- (iv) Management of school

- (v) Type of school (sexwise)
- (vi) Geographical location and
- (vii) Socio-economic status.

Psychological Variables :

- (i) Level of aspiration
- (ii) Social desirability
- (iii) Characteristics preferred by parents
- (iv) Sociability
- (v) Intelligence
- (vi) Ego strength
- (vii) Excitability
- (viii) Dominance
- (ix) Surgency
- (x) Super-ego strength
- (xi) Adventurousness
- (xii) Sensitivity
- (xiii) Passive individualism
- (xiv) Guilt proneness
- (xv) Self sufficiency
- (xvi) Self control and
- (xvii) Ergic tension.

Scholastic Achievement Variables :

Student's achievement data at class IX and X subjects taken into consideration at both these levels were :

- (i) English
- (ii) Mathematics
- (iii) Hindi
- (iv) Social Studies
- (v) General Science and
- (vi) Total Marks.

Statistical Analysis

Data thus collected were scored. Scholastic achievement data were transformed into standard scores so as to make them more comparable. The raw score does not indicate the amount of

achievement which can be compared within the group. The standard score shows the actual position of an individual just where he stands, with reference to the distribution of scores of a particular group.

Furthermore, a comparative study of different groups can be made on the basis of standard scores because they can be directly compared with each other due to having the same positional meaning.

After calculating the mean and standard deviation (Garrett, 1958) of different subject groups the standard scores have been calculated on the basis of Strong's method (1948). The following formula was applied for calculating the standard scores.

$$S. S. = 10 \frac{X - M}{S. D.} + 50$$

where S. S. stands for standard score :

X stands for raw score

M stands for mean of the distribution : and

S. D. stands for standard deviation.

All the data were then transferred on to data cards, and were subjected to univariate, bivariate and multivariate methods of analysis.

Univariate Analyses

- (i) Frequency distribution of all the variables
- (ii) Mean and S. D. of all the variables and
- (iii) t—test.

Bivariate Analyses

- (i) Product-moment correlation (Pearson's 'r') ;
- (ii) X^2 test (Chi—square test) of Association.

Multivariate Analyses

Multivariate statistical methods are used because they make it possible to encompass all the data from an investigation in one

analysis. This approach results in a clearer and better organized account of the investigation than does the piecemeal analysis of the data. It also yields more realistic probability estimate in testing the hypothesis than do separate partial analysis. Kendall (1957) emphasizes that the variates are inter-dependent among themselves so that we cannot split one or more from the others and consider one by itself. Thus, variates must be considered together. According to Bock (1957), behavioural research typically involves problems in which several response variables are observed simultaneously which necessitates the use of multivariate analysis.

(i) **Factor Analysis:** According to Harman (1967) the principal concern of factor analysis is the resolution of a set of variables linearly in terms of (usually) a small number of categories of 'factors'. The resolutions can be accomplished by the analysis of the correlations among the variables. A satisfactory solution will yield factors which convey all the essential information of the original set of variables. Thus the chief aim is to attain scientific parsimony or economy of description.

Results of factor analysis are rarely meaningful without rotation. There are various methods of rotation of results of factor analysis which yield more meaningful factors. In this study the 10×10 inter-correlation matrix of Study Involvement Inventory has been factor analyzed by Principal Components method (Harman, 1967) and results have been rotated using Kaiser's (1958) varimax criterion according to orthogonal axis solution (Fruchter, 1954) to arrive at more meaningful factors. The reasons for selecting the orthogonal solution were :

- (i) it is relatively a simpler procedure and
- (ii) similarity of results.

According to Fruchter (1954) except for instances of highly correlated factors, there is little difference in the intercorrelation of the factors derived from the two approaches, namely, oblique and orthogonal. Also it is difficult to decide how oblique the axes should be permitted to be, before they no longer can be considered independent, but blend into one factor. In the present investigation though the variables are intercorrelated they are not so highly intercorrelated as not to permit the use of the orthogonal axis approach,

(ii) **Stepwise Multiple Regression Analysis :** Stepwise multiple regression analysis is a method of analyzing the collective and separate contributions of two or more independent variables, X , to the variation of a dependent variable Y . The stepwise solution is a kind of multiple regression wherein.

“tests are performed at each step to determine the contribution of each variable already in the equation if it were to enter last. It is thus possible to discard a variable that was initially a good predictor” (Kerlinger and Pedhazur, 1973).

This method seeks the best set of predictors. Variables are added or dropped according to the statistical significance of their contribution to the prediction of criterion (dependent) variable. A stepwise procedure thus allows the data to tell their own story in terms of empirical first order inter-relationship. Multiple correlations also have been computed for predictor variables in stepwise order. B , beta weights, SE of B and F ratios were also calculated.

The square of multiple correlation called the ‘coefficient of multiple determination’ has been used for comparing the proportion of variance accounted for by different sets of variables. In this analysis by multiple regression technique, an attempt has been made to estimate the net effect of a set of predictors and also their joint effect through other set of predictors. Method is referred to as the ‘explained variance decomposition analysis’ (Mukherjee, 1977).

(iii) **Partial Correlation :** “A partial correlation between two variables is one that nullifies the effects of a third variable (or a number of other variables) upon both the variables being correlated.When only one variable is held constant, we speak of first order partial correlation” (Guilford and Fruchter, 1978).

(iv) **Discriminant Function Analysis :** Discriminant function analysis determines the weight to be given to each of the original measurements in order that the resulting composite score will have maximum utility in distinguishing between the members of two groups (Overall and Klett, 1972). F -ratio (Overall and Klett, 1972) has also been computed.

The coding plan prepared for statistical analyses of the data is given in Appendix 1;

CHAPTER 5

CONCEPT OF INVOLVEMENT IN STUDIES

Involvement has been conceived in different ways by different authors. Sherif and Cantril (1947) were the first to use the concept of ego involvement. After that many meanings have been attached to the term involvement.

Ego Involvement

Sherif and Cantril have provided an example of an early effort to amalgamate the work on attitudes into a comprehensive theory of behaviour (Sherif and Cantril, 1945, 1946, 1947). They argue for the value of using attitudes as the core constructs in behaviour. They have emphasized two points which currently retain their theoretical value. First, they argue for a position that the attitudes can be taken as a main unit of psychological study.

“Attitudes are among those components of the psychological make up of the individual which determine that he shall react not in a passive or neutral way, but in a selective and characteristic way especially in relation to certain stimulus situations” (Sherif and Cantril 1945, p. 300).

Second, that a variable source for understanding the nature of attitudes is to be found in studying the nature of judgemental (cognitive) or perceptual processes.

The behaviour can be designed as ego-involved when in the course of development, acquired attitudes related to one's own ego are brought into play in a certain situation by relevant objects, people, or groups, so that either a high degree of participation is produced or attitudes relative to one's own ego, the image of one's ego etc., are called upon.

Sherif and Cantril (1947) define the ego as constellation of attitudes of the type 'what I think of myself', 'what I value', 'what is mine', etc. Thus defined their ego is the self-as-object and not the working ego of psychoanalytic theory. They assert that,

"apart from the constellation of these ego-attitudes there is no such entity as the ego" (1947, p. 4).

Yet by implication their ego is something more than a self-as-object for if the ego becomes involved, it motivates behaviour. Sherif and Cantril's (1947) work is replete with studies and examples of ego as motive. They maintain that when the ego (self) attitudes are activated they energize, direct, and control the person's behaviour that do the same thing; but it is one of the main thesis of their work that the ego attitudes are more effective motivators of behaviours than the non-ego motives are. Thus when a person is given a task to perform he will do it in a more or less perfunctory manner, unless his ego-attitudes are aroused. If he feels, for instance, that his self respect is at stake he will work much harder. It is regrettable that Sherif and Cantril (1947) did not differentiate more clearly between self as object and ego as process.

In a more recent discussion of the self, however, Sherif (1962) uses the terms ego and self interchangeably. They not only both refer, he says, to the individual's attitudes towards himself, towards other people, and towards social institutions, but they also influence his behaviour. This means according to Sherif and Cantril self (or ego) is both object and process.

Sherif and Sherif (1956) also state that :

"an individual is ego involved when one or more ego attitudes participate as factors in determining his experience and behaviour. Ego attitudes become operative as internal factors within the frame of reference at a given time because of their relevance to external stimulus factors. Ego involved activity is goal-directed. Like any other motive, an ego attitude implies specific expectations towards a certain goal, ideal, or value. Whether the individual is aware of the fact or not, ego involved activity produces differential effects on his experience and behavior. When he is ego involved, his reactions are no longer neutral;

they are not haphazardly distributed around an indifference point. His reactions in perceiving, judging, remembering are heavily loaded by the goal-directed nature of the involvement."

Recently Eagley and Manis (1966) reported a related finding. Ego involved subjects responded more negatively to a discrepant communication than less involved subjects. On the basis of this finding it may be concluded that the range of assimilation is inversely related to the degree of personal involvement. Prior to this Sherif and Hovland (1961) had also arrived at the same conclusion when they focussed on involvement as one of the more significant factors creating resistance to persuasion. They saw involvement as reducing attitude change.

Ego Involvement in the Dictionary of the Social Science (1969) also refers to the process (or the state which emerges from that process) by which the ego (q. v) becomes identified with various objects, acts, attitudes, values, and so on the extent that their fate becomes the fate of the ego—a threat to them threatens the ego, and their enhancement exalts the ego. This involvement of the ego leads to particularly intensive, strongly motivated behaviour when such outside elements seem to be pertinent to the action situation. Goldenson (1970) states :

"We do not react to all situations with the same degree of effort or concern. The more deeply our goals and self esteem are concerned, that is, the more ego involved we are, the more intense our reactions."

According to him ego-involvement is a broad concept that brings about many aspects of experience. It helps to account for our inner conflicts, our self concept, and the feelings of frustration, we so often experience.

Concept of Involvement in Education

In the educational context the theme most consistently recurring during the past more than half century can be summarized in a single statement :

"Learning is dependent on the behaviour or the involvement of the learner" (Anderson, 1975).

This belief has been stated in various forms by Morrison (1926). Wheat (1931), Tyler (1950), Carroll (1963) and Roth Kopf (1970). As popular as this belief there has been very little research which has been conducted to test the appropriateness of this belief, particularly in a school learning situation.

Ozcelik (1973) identified student involvement as the major factor in achievement for school learning. Student involvement is treated as a function of perceived instructional quality and of entry variables in the areas of cognition and attitude.

Anderson (1975) investigated the relationship between selected student characteristics, student involvement in learning and achievement. Both naturalistic and experimental studies were conducted. A significant positive relationship was found to exist between student involvement in learning and achievement as well as between student involvement and selected student and environmental characteristics in both studies.

Eugene (1976) also studied the relationship among student involvement and student achievement, and found a positive relationship. Besides, some other researchers have worked on student involvement in school activities and tried to find out its relationship with many other factors.

While studying the significant correlates of secondary school failures Varma (1966) found that scholastic success was due to a high degree of ego involvement and good study habits. The ego involvement indicated the degree of persistence.

A study was conducted by Adams (1975) to see the relationship that might suggest what factors are related to children's choosing active involvement in interactive activities for contributing to children's enjoyment, learning and ability to respond positively to others. Significant correlations were observed between involvement in the activity and self confidence. The correlations also suggested that subjects who did become involved (i) expressed enjoyment, (ii) believed that they were learning, and (iii) gained in ability to respond positively to other classmates. This study indicates that involvement reflects all the three aspects of experience, namely, affective, cognitive and conative.

Involvement as Participation

Many authors have used the term purely in the sense of participation of the student or learner in certain activities. Yanoff's (1973) study, for example, proposed to examine the differential effects of involvement on elementary school children taught with open teaching styles. Involvement in this study was defined as the degree of affect or feeling of being actively involved in one's own learning process.

Ball (1973) also used the term in the sense of class participation and suggested that dividing classes into groups of 5 or 6 students would result in greater involvement and effective learning. Lounsbury and Tornatzky (1975) also used the term involvement in the sense of participation in various activities, that is, group discussion, which produced a significantly greater degree of behavioural commitments. Griffin (1974) also conceptualized involvement of students as personal participation in a learning situation and prepared a direct involvement scale to measure this personal participation.

As a matter of fact, Sherif and Cantril's (1947) concept of ego involvement encompasses more participation on the part of the individual and, therefore, the two have a common basis, that is, involvement of certain ego attitudes.

Carroll (1963) quantified student involvement in learning with the use of a single variable, time. Time according to him was not the 'elapsed time' (the time during which the student is in the presence of the instructor or instructional material); rather time referred to the amount of time that the student was actively involved in learning. He hypothesized several characteristics of the learner and the learning environment that would affect the student involvement. The learner characteristics were defined in terms of variables which were fairly stable (that is, highly resistant to change), such as intelligence, aptitude and motivation.

The results of Carroll's study support to the importance of student involvement in learning as a central variable in the school learning process. The model on which this study is based used achievement as an indicator of the student involvement in learning, and the affective and cognitive entry behaviours as an indicator of the learning environment. The emphasis in education, accordingly

should be on helping the student become involved in the learning process (or task) and maintaining this active involvement (time on task) by providing him with the necessary cognitive pre-requisites, helping him to maintain a high affective entry level, and providing a learning environment which allows for initial variation in student characteristics by offering varying amount of elapsed time and help. According to the author, once this involvement in learning occurs, and is maintained ; learning follows. It is important to note that the antecedent variables which are related to, and affect time on task, can be reasonably defined in terms of learnable, alterable characteristics of the student.

Involvement and Need Satisfaction

A relationship between involvement and need satisfaction has been visualized by a few researchers. Though the number of such studies is a very limited one, these studies indicate that a positive relationship does exist between personal involvement of students in any activity and the satisfaction of their needs.

Perkins (1975) conducted a study to find out this relationship and found a significant positive relationship between the two. Rufus (1976) also arrived at the same conclusions. His study indentified student's psychological needs and college environmental pereception from which a congruence factor was computed and related to involvement in student activities. It was found that there was a significant relationship between activities involvement and satisfaction for male students, not for female students.

To sum up, it is obvious that ego attitudes of the individuals have been considered to be implied in all the ego-involved activities. In some studies ego-needs have also been presumed to be involved. The concept of involvement in this investigation also rests on the concept of need satisfaction.

'Involvement' as Conceptualized in this Investigation

In this investigation involvement is defined as an identification with the task to be accomplished. The degree of involvement will be determined by the (i) number of needs satisfied, and (ii) the extent of their satisfaction through the performance of the task.

When any activity results in satisfaction or perception of satisfaction of certain needs, the activity does not remain merely perfunctory. The individual feels a sense of identification with the activity and enjoys being at it. He tries to do his best in it. In this study it has been postulated that need dissatisfaction or frustration of any one of the needs will give rise to discomfort to the individual and he will strive to satisfy that need. The individual's actual feelings of satisfaction of these needs or the perception of satisfaction of the needs, which is the desired outcome will have a reinforcing effect and will energize the behaviour. On the contrary if the needs are not satisfied, frustration will result and the individual's behaviour will not be reinforced and he will not feel involved in the activity.

The ten needs (Murray, 1938) taken into consideration for this investigation are :

- (i) n—Abasement
- (ii) n—Achievement
- (iii) n—Affiliation
- (iv) n—Aggression
- (v) n—Autonomy
- (vi) n—Defecence
- (vii) n—Nurturance
- (viii) n—Order
- (ix) n—Recognition and
- (x) n—Succorance.

Involvement as conceptualized in this study may be classified as an intrinsic motivation. Intrinsic motivation, as discussed in chapter 2 has been postulated by various authors. Deci (1975), for example states :

“Intrinsically motivated activities are ones for which there is no apparent reward except the activity itself. People seem to engage in the activities for their own sake and not because they lead to an extrinsic reward———. One can observe that there is no apparent reward and that the person is deriving enjoyment from the activity.”

The above definition does not seem to be a very satisfactory one since it does not help one to understand the psychological basis of intrinsic motivation. Berlyne (1971) rightly points out that an activity cannot in any meaningful sense reinforce itself, but rather what it can do is bring about certain internal consequences which the organism experiences as rewarding. The definition of involvement given above addresses itself to the internal consequences, namely, satisfaction of needs which is a rewarding experience for the organism and those behaviours which bring about satisfaction of these needs get reinforced.

In the present investigation the activity is of studies and it is presumed that various ego needs of the individual are satisfied through study related behaviours. The extent of satisfaction of needs is presumed to be the extent of involvement in studies.

Operationally, involvement in studies is defined as an individual's score on the Study Involvement Inventory which has been developed for this investigation.

On the basis of the scores on this inventory the total sample has been divided into three groups as given below :

(i) High Involvement Group : 27 percent top scores on Study Involvement Inventory from the total sample constitute this group.

(ii) Low Involvement Group : 27 percent bottom scores on Study Involvement Inventory from the total sample constitute this group.

(iii) Average Involvement Group : The remaining middle 46 percent scores on Study Involvement Inventory from the total sample constitute this group.

CHAPTER 6

RESULTS

In order to test the hypotheses formulated in chapter 3, various statistical techniques as discussed below have been applied to the data.

Univariate and Bivariate Analysis of Data

Univariate and bivariate methods of statistical analysis are concerned with only one and two variables respectively.

In the present study means and standard deviations have been computed for all the 38 variables for the total sample of 600, and all the three groups, namely, High Involvement, Average Involvement and Low Involvement Groups. These groups are as follows :

Groups	Number of Students
High Involvement	132
Average Involvement	296
Low Involvement	172
Total	600

Product—moment correlation coefficients (Pearson, 1929) were computed between all the 38 variables for the total sample of 600 students.

Table 6.1 shows the inter-correlation matrix.

t—Test : (Ferguson, 1976) was applied to find out significance of difference between the means of the high involvement and low involvement groups.

Chi—Square Test (X^2 —test) : Of association, a non-parametric technique (Siegel, 1956) was applied to find out the association between

the criterion variable, student involvement in studies and background variables, which are in discrete categories.

Multivariate Analysis

“Multivariate analysis is a branch of statistics concerned with multiple measurements that have been made on one or several samples of individuals. The multivariate character lies in the multiplicity of the p -variables and not in the size of the set. Moreover, the variables are inter-dependent so that it is not possible to split them off and study them separately” (Cooley and Lohnes, 1971).

Multivariate techniques used to analyze the data in this investigation are discussed below :

Stepwise Multiple Regression Analysis : This method seeks the best set of predictors. Variables are added or dropped according to the statistical significance of their contribution to the prediction of criterion variable. Stepwise analysis has been applied to all the variables in the data except the total marks at IX and X class levels. In this analysis an attempt has been made to estimate the net effect of each set of predictors separately and then the joint effect of all the sets of predictors. The method is referred to as the ‘explained variance decomposition analysis’ (Mukherjee, 1977).

Partial Correlation : In the present investigation first order partial correlation has been computed between involvement in studies and various psychological variables holding the effect of social desirability constant.

Discriminant Function Analysis : has been used to identify the variables that discriminate between the two extreme groups of students having high and low involvement in studies.

The study of Wood (1971) revealed that the item weight of discriminant function analysis was most effective in distinguishing the extreme groups. Hence the analysis in this study was restricted to the extreme groups only.

Involvement in Studies and Background Variables**Hypothesis I :**

I (a)—This hypothesis states that certain background variables like sex, birth-order, caste of student, management of school, type of school, geographical location of school, and socio-economic status are related to involvement in studies. Tables 6.2 and 6.3 show the results.

Table 6.2
Intercorrelations between Involvement in Studies
and Background Variables (N=600)

Variable	r
Sex	—·121**
Birth-order	—·023
Caste of student	·085*
Management of school	·035
Type of school	—·085*
Geographical location of school	—·201**
Socio-economic status	·069

*—Significant at .05 level.

**—Significant at .01 level.

Table 6.3
Means and Standard Deviations
of Background Variables (N=600)

Variable	Mean	S. D.
Sex	1.603	·450
Birth-order	1.927	·728
Caste of student	1.910	·292
Management of school	1.430	·868
Type of school	1.847	·720
Geographical location of school	1.202	·402
Socio-economic status	45.840	13.545

Note : All the background variables except socio-economic status have been coded.

Inter-correlations in table 6 : 2 show that only sex ($r = -.121$, significant at 1% level), caste of student ($r = .085$, significant at 5% level), type of school ($r = -.085$, significant at 5% level), and geographical location of school ($r = -.201$, significant at 1% level) are related to the involvement in studies.

The results show that girls are more involved in studies than boys. This is confirmed by the findings that students from schools exclusively for girls are more involved. It reveals that girls' needs are satisfied through studies to a greater extent than the boys'. It may be true because boys engage themselves in multifarious types of activities in and outside the home, whereas girls are expected to be engaged in a very limited number and types of activities. They do not go out of the house so much and, therefore, it may be possible that they find more satisfaction of their needs through study related activities.

The results obtained seem to fit in our present cultural context. Women in our culture had more defined roles. Their aspirations have been mainly determined by the external factors such as society and family. Recently there has been an upsurge in the pattern of thinking of girls and women. The enforcement of the constitutional prerogatives has put men and women on equal footing in relation to the world of work. Also, there has been a tremendous expansion in the variety of occupations both for men and women. Hence the present awakening amongst women to strive for entering into almost all occupations. This consciousness in women is evident not only in relation to various fields of occupations but at various levels of occupations also. It is obvious that education is a very potent factor in determining the vocational development of an individual and his employability. Therefore, it is not surprising that girls have a higher involvement in studies. It may be due to their aspirations for equally prestigious occupations as for the men (Gaur, 1973). Also girls have a strong sense of insecurity for in our society a girl's education is not considered an economic need. It is a status symbol in many communities. If the girls fail or do poorly in the school, their education is stopped, they are not sent to the school any more and are got married. While boys are sent to the school inspite of their poor performance. Therefore, in order to continue the education, girls have to be highly motivated to study and have to show good performance in the school and examination,

The correlation in table 6.2 show that none scheduled caste students are more involved in studies. This may be because of the value systems of the scheduled caste and non scheduled caste groups. In the present study, it has been observed that 8.9% of the non scheduled caste students are first generation learners while 48% of the scheduled caste students belong to this category. Studies have shown that there is a wide difference between the attitudes and values of the first generation learners and non first generation learners. The pilot phase of a research conducted in the Educational and Vocational Guidance Unit of National Institute of Education, NCERT, New Delhi (1978) has shown that the first generation learners and non first generation learners differ as regards their work values. Sixteen work values, namely, social service, independence, ability, fame, economic gain, security, power, glamour, leisure, adventure, prestige, education, interest, effect, leadership, and obedience were studied. It was found that the most striking difference between the two groups is evident on education, which is number one in the hierarchy of values with non first generation learners, but is number twelve with first generation learners. Similarly economic gain and glamour are very high for them in the hierarchy of values but they are quite low with the non first generation learners.

Also another important reason of the lack of involvement in scheduled caste students may be a sense of extreme security. In the Indian Constitution many privileges like reservation of seats in colleges, technical and professional institutions, reservation of posts in almost all the jobs at all the levels, relaxation of age limit and educational qualifications etc., have been given to the scheduled castes and other backward classes. Because of this constitutional protection these groups do not feel motivated to do hard work, rather they try to seek gratification of their needs through other non-academic pursuits.

Geographical location of the school is related to the involvement in studies. Students in the urban schools show more involvement than students in the rural schools. This may perhaps be due to the fact that the urban schools provide such education which satisfies the psychological needs of the students to some extent, whereas, the rural schools do not satisfy students' personal needs. Their social and vocational needs are also different which the present

curriculum does not seem to satisfy and, therefore, these students do not feel motivated to study and continue education.

These findings are contrary to the findings of Mehta, et al (1967) and Mehta (1969) who found no difference in students' academic motivation in the rural and urban schools.

Though socio-economic status of the students' family does not show statistically significant relationship with their involvement in studies, there is an indication that higher SES students seem to have a higher involvement. Hayes (1969), Seidel (1970) and Stavros (1972) in their investigations found a definite positive relationship between the two.

Birth-order also does not seem to have statistically significant relationship with involvement in studies. The results, however, point that the eldest or first born child shows more involvement in studies. This may be explained by making an assumption that the first born person who gets dethroned by later born sibs will be anxious about losing his position and losing the love of his parents, and would, thus be oriented towards other activities (preferably the study related activities, because by this time he starts education) to get his needs fulfilled. The first and the only child who by definition does not get dethroned by later sibs is still involved in approval seeking behaviour that has its source in the typically intense dependent relationship that parents form with an only child. The only child, therefore, gets involved in those activities which are preferred by his parents and seeks gratification of his needs through them.

Management of school also does not show significant relationship, but there is an indication that students in Public (private), and Central Schools show more involvement. This may be because the Public and the Central Schools pay more individual attention to the child and try to socialize him according to the needs of the school. These schools are more result-oriented and, therefore, encourage students to feel more involved in studies. Moreover, these schools try to satisfy the students' needs to a greater extent as compared to the Government and Private-aided Schools, where the number of students is more in each class and individual attention may not be possible. It may also not be unreasonable to believe that the differential back-

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grounds of parents have significant implications of their children's interest in scholarly attainments. As Holland (1957) while seeking answers to fundamental questions regarding institutional productivity, concludes that the evidence argues strongly against the 'institutional productivity' hypothesis, variations in institutional productivity are probably due to the divergent proportions of high-aptitude students in these institutions and to differences in their educational motivations, which may be self-evident, but also with respect to underlying attitudes, values and intellectual dispositions. The investigator concludes that differential institutional productivity resides in *who the students are* rather than in *what the institutions do*.

Thistlethwaite (1959, 1959a, 1960), on the other hand, has reached an opposite conclusion, that even if the quality of students is equated, there still remains an appreciable institutional effect. He has found wide variations in productivity independent of the quality of the student body. Thistlethwaite thus emphasizes the school variables which may be more important than the quality of the students.

I (b)—According to this hypothesis, students in high and low involvement groups differ as regards to these background variables. Chi-square test of association was applied to see whether the background variables are independent of or associated with the criterion groups. The results are presented in the following table.

Table 6.4
Results of Chi-square Test for
Background Variables

Variable	df	X ² Value
Sex	1	5.61*
Birth-order	2	2.18
Caste of student	1	0.99
Management of school	3	5.11
Type of school	2	6.81*
Geographical location of school	1	13.73*

*—Significant at .05 level.

**—Significant at .01 level,

Each background variable was studied separately to see its relationship with involvement in studies. The results are presented in the following tables ;

Table 6 : 5
Comparison between High and Low Involvement
Groups in respect of Sex of Students

Code No.	Sex	High Group (N=132)	Low Group (N=172)
1	girls	63	59
2	boys	69	113
Chi-square= 5.61		df=1	Significant at .05 level.

Chi-square test of association between high and low involvement groups in respect of sex indicates a significant difference at 5% level between the two groups. It reveals that significantly more number of girls have high involvement whereas more boys show low involvement in studies.

Table 6 : 6
Comparison between High and Low Involvement
Groups in respect of Birth-order of Students

Code No	Birth-order	High Group (N=132)	Low Group (N=172)
1	First born	42	43
2	Middle born	65	86
3	Last born	25	43
Chi-square=2.18		df=2	Not significant.

The results of the Chi-square test of association between the high and low involvement groups and birth-order of students show no significant difference. The trend, however, reveals that more number of the high and low involvement groups belong to the first born and last born categories respectively.

Table 6 : 7
Comparison between High and Low Involvement
Groups in respect of Caste of Students

Code No.	Caste	High Group (N=132)	Low Group (N=172)
1	Scheduled caste	12	22
2	Non Scheduled caste	120	150
Chi-square=0.99		df=1	Not significant.

The results of the Chi-square test of association between the high and low involvement groups in respect of caste of students indicate no significant difference between the two groups.

Table 6 : 8
Comparison between High and Low Involvement
Groups in respect of Management of School

Code No.	Management of school	High Group (N=132)	Low Group (N=172)
1	Government	105	133
2	Private aided	17	20
3	Public (private)	4	15
4	Central School	6	4
Chi-square=5.11		df=3	Not significant.

The results show that there is no relationship between involvement in studies and management of school.

Table 6 : 9
Comparison between High and Low Involvement
Groups in respect of Type of School (sexwise)

Code No.	Types of school	High Group (N=132)	Low Group (N=172)
1	Girls'	60	53
2	Boys'	55	91
3	Co-education	17	28
Chi-square=6.81		df=2	Significant at .05 level.

The results of Chi-square test of association in the above table show that there is a significant difference between the high and low involvement groups in respect of the type of school. It is obvious that the high involvement group consists of a larger number of students from girls' schools and the low involvement group consists of a larger number of students from boys schools.

Table 6 : 10
Comparison between High and Low Involvement
Groups in respect of Geographical location
of School

Code No.	Geographical location of school	High Group (N=132)	Low Group (N=172)
1	Urban	106	104
2	Rural	26	68
Chi-square=13.73		df=1	Significant at .01 level.

Chi-square test of association between high involvement and low involvement groups in respect of geographical location of schools indicates a significant difference between the two groups at 1% level. The results indicate that significantly more number of high involvement students belong to the urban schools as compared to low involvement students, who come from rural schools.

Involvement in Studies and Psychological Variables :

Hypothesis II :

II (a)—This hypothesis states that level of aspiration is related to involvement in studies. Table 6.11 shows that the correlation between level of aspiration and involvement in studies is -0.042 which is not significant. This correlation denotes almost no relationship between these two variables. Thus hypothesis II (a) has not been supported.

II (b)—The hypothesis that social desirability is related to involvement in studies is also not supported in view of the correlation between these two variables. Table 6.11 shows the correlation as

·074. This may be due to the fact that the Edward's Social Desirability Scale and Study Involvement Inventory measure two different things and the element of social desirability is not included in Study Involvement Inventory in the sense Edward conceptualizes it in the SD scale.

II (c)—This hypothesis states that characteristics preferred by parents are related to involvement in studies. Correlation coefficient between characteristics preferred by parents and involvement in studies is -0.025 (table 6 : 11) which denotes almost no relationship between these two variables. Thus this hypothesis is also not supported by results.

Table 6 : 11
Correlations and First Order Partial Correlations
between Involvement in Studies and Psychological
Variables (N=600)

Variable	r with IIs	Partial r, Partialling Social Desirability
Level of Aspiration	$-.042$	$-.045$
Social Desirability	$.074$	—
C.P.P.	$-.025$	$-.027$
HSPQ Factors		
Sociability	$.185^{**}$	$.176^{**}$
Intelligence	$.112^{**}$	$.105^{*}$
Ego-strength	$.095^{*}$	$.074$
Excitability	$.46$	$.025$
Dominance	$-.075$	$-.079$
Surgency	$.099^{*}$	$.094^{*}$
Super-ego strength	$.212^{**}$	$.391^{**}$
Adventurousness	$.129^{**}$	$.109^{**}$
Sensitivity	$-.017$	$-.004$
Passive Individualism	$-.028$	$-.018$
Guilt proneness	$-.033$	$-.023$
Self sufficiency	$-.055$	$-.052$
Self control	$-.156^{**}$	$.146^{**}$
Ergic tension	$-.034$	$-.027$

*—Significant at .05 level.

**—Significant at .01 level.

II (d)—This hypothesis states that fourteen personality factors like sociability, ego strength, excitability etc., as measured by HSPQ are related to involvement in studies.

To study these relationships zero order correlation coefficients and first order correlation coefficients were computed between these fourteen personality factors and involvement in studies. Table 6.11 presents these correlation coefficients.

The results show that individuals who are highly involved in studies, have higher sociability ($r=.185$ at 1% level), intelligence ($r=.112$ at 1% level), ego strength ($r=.095$ at 5% level), surgency ($r=.099$ at 5% level), superego strength ($r=.212$ at 1% level), adventurousness ($r=.129$ at 1% level), and higher self control ($r=.156$ at 1% level), as compared to those who have low involvement in studies. It is clear from table 6.11 that even the partial correlations of the first order between the involvement in studies and all the personality variables keeping the effect of social desirability constant do not yield different results. Only in the case of ego strength the first order partial correlation becomes insignificant after partialling out the effect of social desirability.

Relationship between various personality characteristics and academic motivation has been studied by various persons. The investigator (Bhatnagar, 1976) in a study to see the efficacy of individual counselling as a guidance technique, found that many psychological factors such as anxiety, nervousness, lack of self confidence etc., were associated with the low academic motivation of bright under-achievers.

Prior to the above findings Goldstein and Heilburn Jr's (1962) research has also indicated that certain personality factors are significantly related to academic motivation.

II (e)—This hypothesis states that high and low involvement groups differ as regards to these psychological variables. In order to test this hypothesis *t*-test was applied to compare the means of the high and low involvement groups. The results are presented in table 6.12.

A look at the results reveals that the high and low involvement mixed groups of boys and girls do not differ significantly in terms

of level of aspiration and social desirability. This may be due to the internalization of social values and goals by the low involvement group also, because of the metropolitan nature of the city of Delhi, whereas the discrepancy in the involvement in studies remains there as the needs satisfied through study vary and the behavioural mechanism requisite for attaining the goals and values have not been internalized. Katz (1967) also arrived at these conclusions while discussing the effect of socialization of academic motivation in minority group children.

Table 6 : 12
Psychological Variables—Mean and S. D. of the High
Involvement and Low Involvement Mixed Groups
and t Value

Variable	H I (N=132)		L I (N=172)		t Value
	Mean	S. D.	Mean	S. D.	
Level of Aspiration	5.008	21.703	5.930	24.435	—0.342
Social Desirability	25.189	4.691	24.564	5.595	1.422
Intelligence	18.432	4.997	16.570	6.534	2.720**
C. P. P.	8.788	1.863	8.901	2.005	—0.503
Sociability	10.295	2.765	9.267	2.909	3.120**
Intelligence (HSPQ)	4.379	1.197	4.006	1.379	2.474*
Ego-strength	9.409	2.691	8.971	2.950	1.333
Excitability	8.629	2.753	8.174	2.541	1.490
Dominance	5.833	2.747	6.326	2.404	—1.663
Surgency	9.765	2.614	9.041	2.479	2.467*
Super-ego strength	11.311	2.387	10.000	2.687	4.422**
Adventurousness	9.455	2.890	8.762	2.927	2.057*
Sensitivity	7.621	2.857	7.797	2.706	—0.546
Passive individualism	7.083	2.266	7.378	2.306	—1.112
Guilt proneness	6.152	2.927	6.808	4.932	—1.357
Self sufficiency	7.500	2.183	7.634	2.205	—0.526
Self control	11.167	2.453	10.302	2.781	2.825**
Ergic tension	6.823	2.931	6.924	2.931	—0.269

*—Significant at .05 level.

**—Significant at .01 level.

Table 6 : 13

**Psychological Variables—Mean and S.D. of the High
Involvement Girls and High Involvement Boys
and t Value**

Variable	H I Girls (N=63)		H I Boys (N=69)		t Value
	Mean	S. D.	Mean	S.D.	
Level of Aspiration	0.731	20.509	8.913	22.025	-2.203*
Social Desirability	23.667	4.518	26.580	4.405	-3.749**
Intelligence	18.159	5.075	18.681	4.912	-0.601
C. P. P	8.849	1.534	8.834	1.946	-0.049
Sociability	10.365	2.565	10.232	2.935	0.276
Intelligence (HSPQ)	4.333	1.234	4.420	1.160	-0.417
Ego strength	9.143	2.777	9.652	2.587	-1.091
Excitability	8.984	2.634	8.304	2.820	1.427
Dominance	5.492	2.894	6.145	2.567	-1.373
Surgency	9.698	2.543	9.826	2.699	-0.280
Super-ego strength	10.857	2.260	11.725	2.425	-2.120*
Adventurousness	8.762	2.860	10.087	2.770	-2.703**
Sensitivity	8.667	2.337	6.667	2.952	4.288**
Passive individualism	7.556	2.122	6.652	2.308	2.334*
Guilt proneness	6.048	2.693	6.246	3.123	-0.390
Self sufficiency	7.079	2.095	7.884	2.190	-2.152*
Self control	11.032	2.624	11.290	2.278	-0.605
Ergic tension	7.302	3.100	6.406	2.700	1.770

*—Significant at .05 level.

**—Significant at .01 level.

Table 6 : 14

Psychological Variables—Mean and S.D. of the Low Involvement Girls and Low Involvement Boys and t Value

Variable	L I Girls (N=59)		LI Boys (N=113)		t Value
	Mean	S.D.	Mean	S.D.	
Level of Aspiration	-3.695	24.860	10.956	22.639	-3.895**
Social Desirability	23.102	5.081	25.327	5.698	2.522*
Intelligence	15.983	5.385	16.876	7.040	0.852
C. P. P	8.568	2.020	9.084	2.200	0.369
Sociability	9.932	2.834	8.920	2.888	2.195*
Intelligence (HSPQ)	4.034	1.314	3.991	1.411	0.193
Ego strength	8.492	2.837	9.221	2.977	-1.551
Excitability	8.644	2.503	7.929	2.527	1.767
Dominance	6.119	2.518	6.434	2.334	-0.818
Surgency	8.881	2.233	9.124	2.594	-0.610
Superego strength	9.593	2.675	10.212	2.669	-1.443
Adventurousness	8.017	2.855	9.150	2.888	-2.453**
Sensitivity	8.847	2.448	7.248	2.672	3.833*
Passive individualism	7.068	2.269	7.540	2.308	-1.281
Guilt proneness	7.305	7.569	6.549	2.631	0.959
Self sufficiency	7.203	2.161	7.858	2.194	-1.868
Self control	10.271	2.791	10.319	2.776	-0.106
Ergic tension	7.153	2.754	6.805	3.013	0.739

*—Significant at .05 level.

**—Significant at .01 level.

The results show that when the high involvement girls and boys are compared (table 6.13), there is a significant difference (at 5% level) in the level of aspiration with boys showing higher mean score (mean=8.913) than girls (mean=0.731). Same pattern is evident when both the sexes having low involvement are compared (table 6.14). The difference is significant (at 1% level) with boys showing higher level of aspiration (mean=10.956), than girls (mean=3.695). Boys show higher level of aspiration because in the present social set up boys are reinforced for broader range of goals than girls who generally have narrow field of goals. This explanation of the differences between the sexes is further confirmed by the results holding the sex constant.

When the sex is held constant, that is, when high and low involvement girls and boys are considered separately, there is no difference in their level of aspiration (tables 6.15 and 6.16 for girls and boys respectively).

As far as the social desirability is concerned, the difference between high involvement boys and girls (table 6.13) is significant at 1% level, with boys showing higher social desirability score (mean=26.580) than girls (mean=23.667). This shows that boys behave in more socially desirable manner than girls. These findings are contrary to the findings of Gupta (1977), who has found that girls show conformity and benevolence and live to help others and do what is socially correct and desirable. Prior to her, Gill and Spilka (1962), and Kelman and Berclay (1963) also concluded that girls were conformists and they preferred to do what was socially correct, desirable and acceptable.

When the low involvement girls and boys are compared (table 6.14), the groups indicate differences (at 5% level) on social desirability. The mean scores indicate that the boys show more socially desirable behaviour (mean=25.327) than girls (mean=23.102). There is, however, no difference between the high and low involvement groups when sex is held constant (tables 6.15 and 6.16 for girls and boys respectively). However, there is an indication that the high involvement group in both the sexes is more socially desirable. This is perhaps because involvement in studies is also a socially desirable trait.

Table 6 : 15
Psychological Variables - Mean and S. D. of the Low
Involvement Girls and Low Involvement Boys
and t Value

Variable	H I (N=63)		L I (N=59)		t Value
	Mean	S.D.	Mean	S.D.	
Level of Aspiration	0.730	20.509	3.695	24.860	1.075
Social Desirability	23.667	4.518	23.102	5.084	0.650
Intelligence	18.159	5.075	15.984	5.385	2.300*
C. P. P	8.849	1.534	8.568	2.020	0.178
Sociability	10.365	2.563	9.932	2.834	0.885
Intelligence (HSPQ)	4.333	1.234	4.034	1.314	1.298
Ego strength	9.143	2.777	8.492	2.837	1.281
Excitability	8.984	2.634	8.644	2.503	0.730
Dominance	5.492	2.894	6.119	2.518	-1.272
Surgency	9.698	2.543	8.881	2.233	1.881
Superego strength	10.857	2.260	9.593	2.675	2.825**
Adventurousness	8.762	2.860	8.017	2.855	1.439
Sensitivity	8.667	2.337	8.847	2.448	-0.417
Passive individualism	7.556	2.122	7.068	2.269	1.227
Guilt proneness	6.048	2.693	7.305	7.569	-1.238
Self sufficiency	7.079	2.095	7.203	2.161	-0.322
Self control	11.032	2.624	10.271	2.791	1.550
Ergic tension	7.302	3.100	7.155	2.754	0.280

*—Significant at .05 level.

**—Significant at .01 level.

Table 6 : 16

**Psychological Variables—Mean and S.D. of the High
Involvement and Low Involvement Boys
and t Value**

Variable	H I (N=69)		L I (N=113)		t Value
	Mean	S.D.	Mean	S.D.	
Level of Aspiration	8.913	22.025	10.956	22.659	-0.597
Social Desirability	26.580	4.405	25.327	5.698	1.562
Intelligence	18.681	4.912	16.876	7.040	1.860
C. P. P	8.834	1.946	9.084	2.200	0.182
Sociability	10.232	2.935	8.920	2.888	2.954**
Intelligence (HSPQ)	4.420	1.160	3.991	1.411	2.125*
Ego-strength	9.652	2.587	9.221	2.977	0.995
Excitability	8.304	2.820	7.929	2.527	0.930
Dominance	6.145	2.567	6.434	2.334	0.779
Surgency	9.826	2.675	9.124	2.594	1.751
Super-ego strength	11.725	2.425	10.212	2.669	3.837**
Adventurousness	10.087	2.770	9.150	2.888	2.155*
Sensitivity	6.667	2.952	7.248	2.672	-1.367
Passive individualism	6.652	2.308	7.540	2.308	-2.517*
Guilt proneness	6.246	3.123	6.549	2.631	-0.699
Self sufficiency	7.884	2.190	7.858	2.194	0.077
Self control	11.290	2.278	10.319	2.776	2.446
Ergic tension	6.406	2.699	6.805	3.013	-0.902

*—Significant at .05 level.

**—Significant at .01 level.

The groups do not show any difference as far as the characteristics preferred by parents are concerned. It shows that both the groups have the same perception of the characteristics expected by their parents which is perhaps not indicative of actual characteristics preferred by parents.

Other Personality Variables : The results indicate (table 6 : 12) that the high and low involved mixed groups show significant differences with respect to certain personality characteristics like sociability (at 1% level), surgency (at 5% level), super-ego strength (at 1% level), adventurousness (at 5% level), and self control (at 1% level), with the high involvement group showing higher mean score than the low involvement group. This means that the girls and boys having high involvement are outgoing, warm hearted and easy going whereas those who are not so involved are reserved, detached and critical. The high involvement students are more conscientious, persevering, rule bound, have stronger super-ego strength, are venturesome, socially bold, uninhibited, spontaneous, controlled, socially precise, self disciplined and have higher self concept control.

When the sex is held constant, that is, in case of high and low involvement groups of girls (table 6 : 15) the difference is significant (at 1% level) in super-ego strength only, whereas the high and low involvement groups of boys (table 6 : 16) show significant differences on sociability (at 1% level), super-ego strength (at 1% level), adventurousness (at 5% level), passive individualism (at 5% level), and self control (at 5% level). On all these characteristics, except passive individualism, the high involvement boys show higher score.

When the two sexes are compared on these personality variables (table 6 : 13), it becomes clear that high involvement groups of girls and boys show significant differences on super-ego strength (at 5% level) adventurousness (at 1% level), with boys showing higher mean scores on both, sensitivity (at 1% level) and passive individualism (at 5% level) with girls showing higher score on both, and self sufficiency (at 5% level) with boys having higher self sufficiency.

Low involvement groups of boys and girls on comparison show (table 6 : 14) that these two sexes differ significantly on three personality variables, namely sociability (at 5% level) with girls having higher mean score, adventurousness (at 5% level) where boys show higher

mean score and sensitivity (at 1% level) with girls showing higher sensitivity. Differences in personality variables of both the sexes may be due to differences in socialization processes and child rearing practices in the society. The role expectancies between the boys and girls are different in the society with emphasis on traditional feminine roles for girls. There is no dearth of evidence that different kinds of child rearing practices lead to different kinds of personality and behaviour patterns (Goodenough, 1957, and Moss, 1967).

Involvement in Studies and Scholastic Achievement :

Hypothesis III :

III (a)—This hypothesis states that the scholastic achievement of students is related to their involvement in studies. To test this hypothesis product moment correlations were computed between study involvement index and marks in all the school subjects as well as the total marks attained at the IX and X class levels. The correlations are presented in table 6 : 17.

Table 6 : 17

Correlations between Scholastic Achievement and Involvement in Studies (N=600)

School Subjects			r with IIs
English	Class	X	.136**
Mathematics	"	"	.140**
Hindi	"	"	.210**
Soc. Studies	"	"	.147**
Gen. Science	"	"	.137**
Total Marks	"	"	.196**
English	Class	IX	.134**
Mathematics	"	"	.117**
Hindi	"	"	.260**
Soc. Studies	"	"	.184**
Gen. Science	"	"	.129**
Total Marks	"	"	.196**

** — Significant at .01 level.

The table reveals that all the school subjects are very highly significantly related to the involvement in studies (at 1% level). Students who get high marks in school subjects are highly involved in studies.

A lot of work has been done to study the relationship between scholastic achievement and academic motivation but the findings are equivocal.

Brams (1972) investigated the relationship between academic achievement and the personal need satisfaction of students. 250 IX grade students served as the population of his study. He found a positive relationship between satisfaction of students' personal needs and their academic achievement.

Sutton (1961) also concluded a positive relationship between the two on the basis of a study on school children that a child's poor performance may be due to lack of basic ability or lack of motivation of positive emotional involvement.

Mckeel (1968) investigated the relationship between academic performance of engineering students and certain personality and environmental factors. He found a positive relationship between them. Similarly Schuldt and Smee (1968) revealed that higher personality needs accounted for higher achievement of the students and low scores on the needs accounted for low achievement of students.

Singh (1965) also concluded that academic motivation was positively related to the academic achievement of college students.

On the contrary certain researches show that these two are not related at all. Barial (1966) and Eugene (1976), example, found no significant relationship between student involvement and student achievement.

Certain authors are of the opinion that motivation should be supplied from outside. Staats (1968), for instance, regards motivation as an entity which should be supplied initially extrinsically. He assumes, as Skinner (1968) makes explicit that reinforcement which

is supplied from outside forces is the most effective, if not, basically the only kind of motivation. Atkinson's model (1964) of motivation also, which is specific to achievement situations, emphasizes that a cognitive model of motivation would include extrinsic as well as intrinsic motivation to be complete.

Academic achievement in this study, therefore, may be seen as a reinforcement from outside and thus providing extrinsic motivation to the individual to feel more involved in studies.

Table 6 : 18

**Scholastic Achievement—Mean and S.D. of the High
Involvement and Low Involvement Mixed Groups
and t Value**

Variable		H I (N=132)		L I (N=172)		t Value
		Mean	S.D.	Mean	S.D.	
English	Class X	49.773	8.823	47.372	9.516	2.247*
Mathematics	„ „	50.955	10.934	47.215	9.266	3.224**
Hindi	„ „	50.735	10.361	46.169	9.846	3.918**
Soc. Studies	„ „	50.227	11.427	46.791	10.907	2.667**
Gen. Science	„ „	50.879	9.171	47.762	9.603	2.860**
Total Marks	„ „	51.000	10.483	46.355	10.432	3.840**
English	Class IX	50.432	9.165	47.808	8.894	2.516*
Mathematics	„ „	52.205	10.541	49.134	9.495	2.664**
Hindi	„ „	52.588	10.574	46.052	8.769	5.883**
Soc. Studies	„ „	51.424	10.427	46.610	8.565	4.417**
Gen. Science	„ „	50.545	10.115	48.384	8.676	2.003*
Total Marks	„ „	54.909	10.922	50.244	8.890	4.104**

*—Significant at .05 level.

**—Significant at .01 level,

III (b)—High and low involvement groups differ as regards to their scholastic achievement. t-test was applied to see the difference in the achievement of high and low involvement groups on various school subjects.

It is observed from table 6:18 that all the school subjects both at class IX and X levels distinguish clearly between the high and low involvement groups with high groups showing higher mean values on all the school subjects.

Table 6 : 19

**Scholastic Achievement—Mean and S.D of the High
Involvement Girls and High Involvement Boys
and t Value**

Variable		H I Girls (N=63)		H I Boys (N=69)		t Value
		Mean	S.D.	Mean	S.D.	
English	Class X	49.475	9.377	50.043	8.336	-0.368
Mathematics	„ „	51.175	11.293	50.754	10.590	0.221
Hindi	„ „	49.079	11.646	52.246	8.760	-1.775
Soc. Studies	„ „	50.444	12.254	50.029	10.613	0.209
Gen. Science	„ „	50.952	10.110	50.812	8.220	0.881
Total Marks	„ „	50.603	12.101	51.362	8.733	-0.416
English	Class IX	51.143	9.208	49.783	9.078	0.854
Mathematics	„ „	53.460	10.826	51.058	10.139	1.316
Hindi	„ „	53.349	9.255	51.884	11.604	0.797
Soc. Studies	„ „	51.444	12.1.2	51.406	8.606	0.213
Gen. Science	„ „	50.794	9.648	50.319	10.518	0.269
Total Marks	„ „	55.905	11.251	54.000	10.531	1.005

Table 6 : 19 reveals that high involvement girls and boys do not show significant difference in their achievement on various school subjects. There does not seem to be much difference between the achievement of both the sexes having high involvement in studies,

Table 6 : 20

**Scholastic Achievement—Mean and S.D of the Low
Involvement Girls and Low Involvement Boys
and t Value**

Variable		L I Girls (N=59)		L I Boys (N= 113)		t Value
		Mean	S.D.	Mean	S.D.	
English	Class X	49.847	9.662	46.080	9.178	2.510*
Mathematics	„ „	47.051	9.482	47.301	9.151	—0.168
Hindi	„ „	44.593	11.472	46.991	8.768	—1.527
Soc. Studies	„ „	49.492	9.837	45.381	11.169	2.385*
Gen. Science	„ „	50.271	8.910	46.451	9.691	2.521*
Total Marks	„ „	47.712	10.615	45.646	10.265	1.238
English	Class IX	50.407	10.056	46.451	7.889	2.834**
Mathematics	„ „	49.153	10.312	49.124	9.040	0.188
Hindi	„ „	48.695	9.234	44.673	8.184	2.927**
Soc. Studies	„ „	47.780	9.132	46.000	8.188	1.300
Gen. Science	„ „	49.136	10.582	47.991	7.460	0.823
Total Marks	„ „	51.966	10.151	49.345	8.009	1.855

*—Significant at .05 level.

**—Significant at .01 level.

Low involvement girls and boys, however, show significant difference in achievement (table 6 : 20) in English (at 5% level), Social Studies (at 5% level) and General Science (at 5% level) at class X level and on English (at 1% level), and Hindi (at 1% level) at class IX level. It is clear from the table that the difference in achievement of both the sexes is greater at Class IX level but at class X level the difference has narrowed down. This may be due to the fact that the students have

to appear in a public examination at the end of class X and girls and boys both are equally concerned about their performance in this examination which is the first public examination of their life and the result of this examination has implications for further education as well as employment.

Studies done by Coleman (1961) and Norman, et al (1962) show that girls tend to over-achieve in their earlier years upto high school. They get off to a very good start in speaking, reading, writing, counting, sentences, mathematics and perceptual speed. But unfortunately they end up worse.

Table 6 : 21

Scholastic Achievement -- Mean and S.D. of the High Involvement and Low Involvement Girls and t Value

Variable			H I (N=63)		L I (N=59)		t Value
			Mean	S. D.	Mean	S.D.	
English	Class X		49.476	9.377	49.847	9.662	-0.215
Mathematics	, ,		51.175	11.293	47.051	9.482	2.177*
Hindi	, ,		49.079	11.646	44.593	11.472	2.142*
Soc. Studies	, ,		50.444	12.254	49.492	9.837	0.477
Gen. Science	, ,		50.952	10.110	50.271	8.910	0.397
Total Marks	, ,		50.603	12.101	47.712	10.615	1.399
English	Class IX		51.143	9.208	50.407	10.056	0.422
Mathematics	, ,		53.460	10.826	49.153	10.312	2.247*
Hindi	, ,		53.349	9.255	48.695	9.234	2.779**
Soc. Studies	, ,		51.444	12.112	47.780	9.132	1.877
Gen. Science	, ,		50.794	9.648	49.136	10.582	0.905
Total Marks	, ,		55.905	11.251	51.966	10.151	2.025*

*—Significant at .05 level, **—Significant at .01 level.

Table 6 : 22

**Scholastic Achievement—Mean and S. D. of the High
Involvement and Low Involvement Boys and
t Value**

Variable		H I (N=69)		L I (N=113)		t Value
		Mean	S. D.	Mean	S. D.	
English	Class X	50.043	8.336	46.080	9.178	2.925**
Mathematics	„ „	50.754	10.590	47.301	9.151	2.325*
Hindi	„ „	52.246	8.760	46.991	8.768	3.924**
Soc. Studies	„ „	50.029	10.613	45.381	11.169	2.775**
Gen. Science	„ „	50.812	8.220	46.451	9.691	3.115**
Total Marks	„ „	51.362	8.733	45.646	10.265	3.851**
English	Class IX	49.783	9.078	46.451	7.889	2.609**
Mathematics	„ „	51.058	10.139	49.124	9.040	1.337
Hindi	„ „	51.884	11.604	44.673	8.184	4.906**
Soc. Studies	„ „	51.406	8.606	46.000	8.188	4.238**
Gen Science	„ „	50.319	10.518	47.991	7.460	1.743
Total Marks	„ „	54.000	10.531	49.345	8.009	3.369**

*—Significant at .05 level. **—Significant at .01 level.

When the sex is held constant it is found that the high and low involvement girls show significantly different means on Mathematics and Hindi at X class and Mathematics, Hindi and Total Marks at IX class level (table 6 : 21). The high and low involvement boys, however, show significant difference on all the school subjects except on Mathematics and Gen. Science at class IX level (table 6 : 22).

Involvement in Studies and Intelligence**Hypothesis IV :**

IV (a)—This hypothesis states that intelligence of a student is related to involvement in studies.

Correlation coefficient was computed between intelligence and involvement in studies and is shown as under :

Variable	r with IIS
<hr/>	
Intelligence	·148**

N=600

**—Significant at ·01 level.

It is clear from the correlation coefficient that there is a highly significant relationship between involvement in studies and intelligence and the hypothesis is supported.

IV (b)—According to this hypothesis students having high and low involvement in studies will show a significant difference in their intelligence.

To test this hypothesis, the results of the analysis of two extreme groups of high and low involvement with regard to intelligence have been considered.

The value of 't' as shown in table 6 : 12 is significant at 1% level which indicates that the two extreme groups differ significantly in their intelligence in the sample investigated. Thus this hypothesis is also supported.

French (1957) studied joint effects of intelligence and achievement motivation on problem solving and found a significant interaction between them. Among those subjects who were high in motivation, performance was positively related to their intelligence.

In this investigation when the high involvement girls and boys (table 6 : 13), and low involvement girls and boys (table 6 : 14) are compared, they do not show significant difference in intelligence. High and low involvement boys also do not show significant difference (table 6 : 16). But both the groups of girls show significant difference (at 5% level) in intelligence (table 6 : 15).

These findings are in line with the findings of McClelland, et al (1953), Desai (1971), and De and Jha (1978).

Prediction of Involvement in Studies

Hypothesis V :

V (a)—This hypothesis states that background, psychological and scholastic variables will predict student involvement in studies. To test this hypothesis, a Stepwise Multiple Regression Analysis was performed. This method enables us to separate out the most relevant independent Variables from the set studied for prediction. Since three sets of independent variables were used to predict the criterion variable, a method referred to as the 'explained variance decomposition analysis' (Mukherjee, 1977) was used to see the separate as well as the joint contribution of each set in explaining the variance in the criterion variable.

The first set of predictors consisted of 7 background variables. The second set consisted of 18 psychological variables and the third set consisted of 10 scholastic variables. In the fourth set of predictors all the 35 variables were combined and treated as one set of predictors of student involvement in studies.

The square of multiple correlation, called the coefficient of multiple determination was used for comparing the proportion of variance in the student involvement scores accounted for by different sets of predictors.

Table 6 : 23 presents significant background variables predicting involvement in studies. The table shows that only geographical location and type of school, are significant predictors of the criterion variable.

Table 6 : 23
Stepwise Multiple Regression Analysis of Background Variables as
Significant Predictors of Involvement in Studies (N=600)

Variable	Regression coefficient	S. E. of Reg. Coeff.	t Value	Intercept	R	R ²	Incre- ment in R ²	F ratio	df
Geographical location	-5.163	1.030	-5.30**	61.156	.201	.040	—	25.27**	1, 598
Type of school	-1.378	0.945	2.74**	63.968	.229	.052	.012	7.50**	1, 597

**—Significant at .01 level.

Table 6 : 24
Stepwise Multiple Regression Analysis of Psychological Variables
as Significant Predictors of Involvement in Studies (N=600)

Variable	Regression coefficient	S. E. of Reg. Coeff.	t Value	Intercept	R	R ²	Increase in R ²	F ratio	df
Super-ego strength	.598	.138	4.33**	48.291	.212	.045	—	28.05**	1, 598
Sociability	.422	.126	3.34**	43.931	.266	.071	.026	16.25**	1, 597
Intelligence	.162	.062	2.60**	41.286	.289	.084	.013	8.67**	1, 596
Self control	.308	.140	2.20*	38.746	.304	.092	.008	5.33*	1, 595
Excitability	.293	.134	2.18*	35.539	.316	.100	.008	5.33*	1, 594

*—Significant at .05 level.

**—Significant at .01 level.

Table 6 : 25
Stepwise Multiple Regression Analysis of Scholastic Achievement Variables
as Significant Predictors of Involvement in Studies (N=600)

Variable	Regression coefficient	S. E. of Reg. Coeff.	t Value	Intercept	R	R ²	Increase in R ²	F ratio	df
Hindi Class IX	.185	.042	4.39**	44.301	.260	.068	—	43.51**	1, 598
Hindi Class X	.085	.043	1.98*	42.400	.272	.074	.006	3.75	1, 597

** — Significant at .01 level.

Table 6 : 24 shows significant psychological variables. It is obvious from the table that super-ego strength, sociability, intelligence, self control and excitability are significant predictors.

Scholastic achievement variables, when studied separately as shown in table 6 : 25 reveals that Hindi both at IX and X class levels is a significant predictor of involvement in studies.

When all these three sets of variable are studied together, it is found that significant predictors are Hindi, super-ego strength, sociability, self control, geographical location, SES, and sex of student in that order (table 6 : 26).

The findings thus indicate that it is a combination of personal, situational and achievement variables (related to need satisfaction of the student) which results in higher involvement in studies. Table 6 : 27 shows the relative contribution of all these variables, separately as well as jointly in prediction of the criterion variable. A comparative look at the multiple correlations and the percentages of variance accounted for by these three sets of variables separately in the criterion variable show in table 6 : 27 reveals that the psychological variables contribute the maximum ($R=.343$, 11.8%), followed by the variance-contribution due to the scholastic achievement variables ($R=.283$, 8.0%). However, the variance explained by background variables is not much less than the variance predicted by achievement variables ($R=.247$, 6.1%).

However, it may also be observed that the combination of all the three sets of independent variables yields the maximum contribution ($R=.429$, 18.4%) for the prediction of involvement in studies (table 6 : 27).

Results of this investigation suggest that the intrinsic factors are most important in determining a student's motivation for studies. Deci (1976) also has emphasized that internal states do cause behaviour and cognitions play a central part in energizing the behaviour. Scott (1976) views intrinsic motivation as some form of internal states presumably distinguishable from the state brought about by the occurrence of reinforcing event and are important determinants of behaviour.

Table 6 : 26
Stepwise Multiple Regression Analysis of Combined Variables as Significant Predictors of Involvement in Studies (N=600)

Variable	Regression coefficient	S. E. of Reg. Coeff.	t Value	Intercept	R	R ²	Incr-ment in R ²	F ratio	df
Hindi	.203	.038	5.40**	44.301	.260	.068	—	43.51**	1, 598
Super-ego strength	.602	.132	4.58**	36.815	.335	.112	.044	29.33**	1, 597
Sociability	.338	.121	2.79**	33.906	.360	.130	.018	12.00**	1, 596
Self control	.280	.136	2.06*	31.450	.371	.138	.003	5.71*	1, 595
Geographical location	—3.238	.981	—3.30**	35.862	.381	.145	.007	5.00*	1, 594
SES	— .085	.030	—2.81**	39.490	.393	.154	.009	6.43*	1, 593
Sex of student	—1.722	.702	—2.45*	43.352	.403	.162	.008	5.71*	1, 592

* —Significant at .05 level.

** —Significant at .01 level.

Table 6 : 27

**Multiple Regression Analysis of Measures of Background, Psychological Variables
and Scholastic Achievement as Predictors of Involvement in Studies**

Criterion Variable	PREDICTOR VARIABLES											
	Background Variables			Psychological Variables			Scholastic Achievement			Combined		
	No. of Vari-ables	R	% of Vari-ance	No. of Vari-ables	R	% of Vari-ance	No. of Vari-ables	R	% of Vari-ance	No. of Vari-ables	R	% of Vari-ance
Involvement in studies	7	.247**	6.1	18	.343**	11.8	10	.283**	8.0	35	.429**	18.4

**—Significant at .01 level.

Furthermore, certain environmental variables also have been found to influence student involvement in studies. Lewin (1951) has already emphasized the importance of these forces in determining an individual's behaviour.

Significant scholastic achievement variables suggest that extrinsic motivation also contributes to the intrinsic motivation, namely, study involvement. Atkinson (1957, 1964) also emphasizes both intrinsic and extrinsic motivation in a cognitive model of behaviour. Furthermore, the results indicate that Hindi both at IX and X class levels is a significant predictor. This may reveal the importance of language in involvement in studies. Hunt (1964a, 1964b) emphasizes throughout his writings the tremendous significance of the role of parent-child verbal interaction for cognitive development of the child. The language serves an important role in shaping child's intellectual development, especially the development of the abstraction and conceptual learning. A closely related factor is intelligence which is a significant predictor.

Thus, the results of these analyses partially support the hypothesis. There may be various other factors which have not been included in the study and which would have contributed in the prediction of the involvement in studies.

V (b)—This hypothesis states that students in high and low involvement groups differ as regards to certain background, psychological and scholastic achievement variables in a multivariate combination.

In order to test this hypothesis, a two group discriminant function analysis was applied. F -ratio was calculated to be 3.034 which is significant at 1% level for 35 and 268 degrees of freedom. The order of discriminant function coefficients according to importance as shown in table 6 : 28 is : geographical location, sex of student, type of school, birth-order, super-ego strength, caste, intelligence, passive individualism, excitability, surgency, Hindi, and so on.

The findings of the discriminant function analysis corroborate the results of the t -test, which indicates that the univariate and multivariate analyses, both reveal almost the same set of variables which discriminate between the two extreme groups.

Table 6 : 28

**Discriminant Function Analysis of all the 35
Variables of High and Low Involvement Groups**

Variable	Upper Mean (N=132)	Lower Mean (N=172)	Mean Difference	Discriminant Function Coefficient
Management of school	1.326	1.361	-0.055	0.050
Type of school	1.675	1.855	-0.180	-0.239
Geographical location	1.197	1.395	-0.198	-0.875
Sex of student	1.523	1.657	-0.134	-0.736
Birth order	1.871	2.000	-0.129	-0.217
Caste	1.924	1.872	0.052	0.132
S. E. S.	45.409	43.576	1.834	-0.040
Level of aspiration	5.008	5.930	0.822	0.018
Social desirability	25.189	24.564	0.625	0.009
Intelligence	18.432	16.570	1.862	0.003
C. P. P.	8.788	8.901	-0.123	0.015
Sociability	10.295	9.267	1.028	0.021
Intelligence (HSPQ)	4.379	4.006	0.373	0.192
Ego strength	9.409	8.971	0.438	0.033
Excitability	8.629	8.174	0.455	0.163
Dominance	5.833	6.326	-0.493	0.018
Surgency	9.765	9.041	0.724	0.102
Super-ego strength	11.311	10.000	1.311	0.211
Adventurousness	9.455	8.762	0.693	0.048
Sensitivity	7.621	7.797	-0.176	-0.026
Passive individualism	7.083	7.378	-0.295	-0.169
Guilt proneness	6.152	6.808	-0.656	-0.072
Self sufficiency	7.500	7.634	-0.134	-0.046
Self control	11.167	10.302	-0.865	0.065
Ergic tension	6.833	6.924	-0.091	0.059

Contd.

English	Class	X	49.773	47.372	2.401	-0.027
Mathematics	„	„	50.955	47.215	3.740	0.011
Hindi	„	„	50.735	46.169	4.566	0.014
Soc. Studies	„	„	50.227	46.791	3.436	-0.018
Gen. Science	„	„	50.879	47.762	3.117	0.006
English	Class	IX	50.432	47.808	2.624	-0.007
Mathematics	„	„	52.205	49.134	3.071	0.001
Hindi	„	„	52.588	46.052	6.536	0.083
Soc. Studies	„	„	51.424	46.610	4.814	0.029
Gen. Science	„	„	50.545	43.384	2.161	-0.035

F-ratio=3.034**

**—Significant at .01 level.

Involvement in Studies and Need Satisfaction

Hypothesis VI :

This hypothesis states that high and low involvement groups differ as regards the satisfaction of ten needs, namely, n—Abasement, n—Achievement, n—Affiliation, n...Aggression, n—Autonomy, n—Defrence, n—Nurturance, n—Order, n—Recognition, and n—Succorance. To test this hypothesis mean difference was found out between all the ten need areas of 50 randomly selected students from each of the two extreme groups. Table 6.29 shows the means of both the groups and t—values.

It is clear from the table that there is a significant difference between all the need areas of the high and low involvement groups except in n—Aggression, though on this area also it is apparent that the high involvement group shows higher mean score than the low involvement group. It may, therefore, be concluded that the high involvement group finds more satisfaction of all the needs through studies as compared to the low involvement group.

Analysis of the results of the study done by Schuldt and Smee (1968) revealed that higher personality needs account for higher achievement of the student and low scores on needs account for low achievement of students. The results of this hypothesis corroborate these findings.

Table 6 : 29

**Need Areas—Mean and Mean Difference between High
and Low Involvement Groups and t Value**

Need area	H I Group (N=50) Mean	L I Group (N=50) Mean	Mean difference	t Value
n—Aba.	5.12	3.40	1.72	4.30**
n—Ach.	7.92	2.92	5.00	10.20**
n—Aff.	7.84	2.80	5.04	10.29**
n—Agg.	4.52	3.80	0.72	1.36
n—Aut.	5.24	3.76	1.48	2.60*
n—Def.	7.76	3.16	4.60	3.54**
n—Nur.	6.04	3.52	2.52	5.86**
n—Ord.	7.92	2.76	5.16	10.12**
n—Rec.	7.68	2.76	4.92	11.44**
n—Succ.	7.52	3.24	4.28	7.78**

*—Significant at .05 level.

**—Significant at .01 level.

Model of Involvement in Studies

It has been established that individual behaves to satisfy his needs. He feels the discomfort and tension which arises as a result of the non-fulfilment of these needs. This feeling of discomfort gives rise to an awareness that this discomfort may be removed and satisfaction felt. All this information goes to the central information processing system where the situation is reviewed and decisions are taken for goal directed behaviour and setting of goals to achieve satisfaction. The decision making of the individual is affected by various internal and external factors. These factors have been

studied in this investigation and model presented here has been partially tested through regression.

The factors which influence the decision of the individual are certain background variables, such as the geographical location of the school, type of school, sex etc., personality characteristics like super-ego strength, sociability, intelligence, self control and excitability. Besides, scholastic achievement provides extrinsic motivation which gives further direction to individual's behaviour.

Scholastic achievement has been included in the model to corroborate Atkinson's (1957, 1954) model of achievement motivation, wherein he emphasizes that both intrinsic and extrinsic motivation should be included in a cognitive model of behaviour to make it complete.

A MODEL OF INVOLVEMENT IN STUDIES

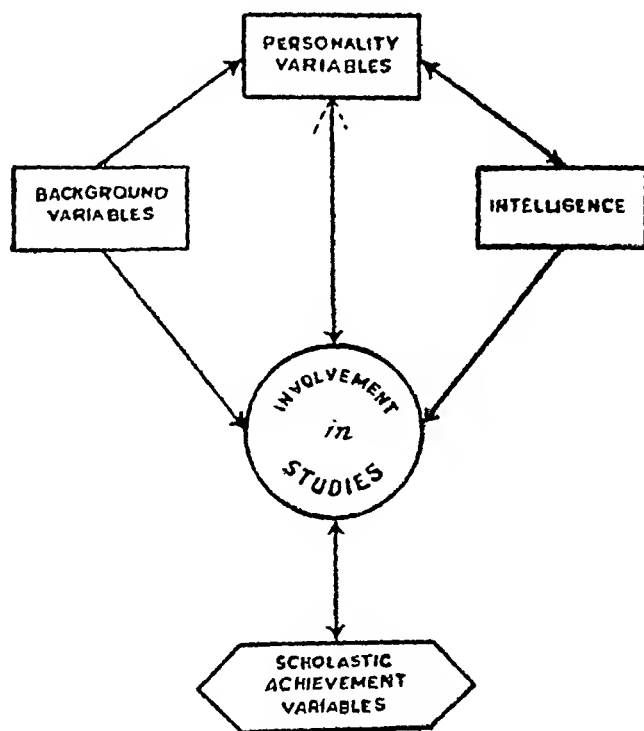


Fig. 6 : 1

The model (Fig. 6.1) shows that there is an interaction among various variables also. It is assumed that these variables affect the students' achievement through their involvement in studies and achievement in turn serves as an extrinsic motivation for involvement in studies.

The model thus depicts a few internal and external motivating factors which could be visualized as affecting the individual's study involved behaviour, in the light of the cognitive conception of intrinsic motivation, emphasized in this investigation.

CHAPTER 7

CONCLUSION AND SUGGESTIONS

Findings

1. The findings show that girls are more involved in studies as compared to boys. Perhaps this is because of the fact that girls find more satisfaction of their needs through studies than boys, who have a broader field of activities and seek need gratification elsewhere. Another plausible explanation of this difference may be girls' strong sense of insecurity because of the age old social and cultural pattern of the country. In order to continue education girls have to show good results in the academic and scholastic pursuits. Boys, on the other hand, do not face this insecurity since their education is an economic need of the family and society. Girls' more involvement in studies may also be because of their effort to overcome the social and economic insecurity by procuring better placement in the world of work and a better status in the society.

2. The non scheduled caste students show more involvement than the scheduled caste students. This may be because of the different sets of social values, attitudes, and aspirations etc., held by these two groups. Furthermore, a large number of scheduled caste students are first generation learners, whose parents' attitudes and value orientation may also affect their behaviour. Moreover, the scheduled caste and backward classes may be having a strong sense of security as a consequence of the constitutional prerogatives given to them. These groups, therefore, seek gratification of their needs through non-academic pursuits.

3. The students from urban schools show more involvement than the students from rural schools. It seems that the present day educational curriculum, which is uniform for all, caters, more to the personal, social, and vocational needs of the urban and middle class children than to the needs of the rural and lower class youth. Time

and again, it has been reiterated that school curriculum should be planned and implemented according to the needs of all the students.

4. It seems that the Public (private) and the Central Schools provide more need satisfaction than the Government and Private-aided Schools. The type of school environment, attitudes and behaviours of teachers towards each other and towards students may be responsible for this difference. Intervening variables like socio-economic environment at home, educational and occupational levels, value systems and set of attitudes held by parents of the students may be some other important factors leading to this difference.

5. Though the findings reveal that students having high involvement in their studies are outgoing, warm-hearted, easy-going, conscientious, persevering, rule bound, have stronger super-ego strength, are venturesome, socially precise, self disciplined, and have high self concept control, sex differences are obvious on adventurousness, super-ego strength, self-sufficiency, sensitivity and passive individualism. On the first three characteristics boys show higher score whereas on the last two girls show higher score. This may be due to the difference in the process of socialization of both these sexes. Boys are given more freedom and are allowed more permissive behaviour, adventure and risk taking than girls who are over-protected and negatively reinforced for hyper-activity and certain types of behaviour. No wonder both the sexes develop different personality characteristics against this background.

6. Boys having high involvement in studies show more socially desirable behaviour than girls. Social change which is taking place rapidly in the country seems to be responsible for new roles for girls in the society, who are giving up the traditional age old feminine roles. Also, boys belonging to both high and low groups, show higher level of aspiration than girls. The reason of this may again be inherent in the social pattern in which boys are positively reinforced for broader range of goals. Though girls are also striving hard to attain new goals and tread over new paths, some traditional values and role perceptions are still held by parents and a majority of girls themselves.

7. High involvement and low involvement groups do not differ as regards the perception of the characteristics preferred by

parents, which is perhaps not indicative of the actual characteristics preferred by parents. Some difference would have been evident if this information was collected from the parents themselves.

8. Results of the study show that there is a highly significant relationship between intelligence and involvement in studies. These findings are in line with the cognitive explanation of study involved behaviour. In the cognitive model of motivation, it is assumed that the individuals process information coming from various sources and take decisions as to what to do. The central cognitive system does this processing and decision making. Intelligence is a part of this cognitive system. Individuals having higher intellectual levels are able to process this information more efficiently and can take decisions quickly. In the present study also an individual having higher intelligence can have a better subjective probability estimate of the potential satisfaction of various needs through certain goal directed behaviours and can take correct decisions in order to attain the desired goals.

9. It has been observed that three sets of variables, namely, background, psychological, and scholastic achievement variables contribute in the prediction of involvement in studies (though certain variables in each set do not account significantly for variance in the criterion variable). The psychological variables account for maximum variance (11.8%), scholastic achievement variables come next which explain 8% of the variance and background variables contribute 6% of the variance. All these variables when considered jointly account for 18.4% of the variance. Significant predictors of involvement in studies are ; Hindi, super-ego strength, sociability, self control, geographical location, SES and sex of student in that order. This shows the importance of extrinsic and intrinsic motivation in determining involvement in studies.

10. In this research a high positive relationship is found between satisfaction of students' various psychological needs (Involvement in Studies) and their academic achievement which suggests that in an attempt to foster higher achievement and learning among students, educators should create more satisfying school environments through meticulously planned curricular experiences which accomodate students' personal need dispositions, so that they

find the environment more satisfying and stimulating regardless of such personal characteristics as sex, intelligence, family background etc.

Suggestions

As mentioned earlier it is for the first time that an investigation into the student involvement in studies has been carried out in India or elsewhere. The study reveals some important findings given earlier but the investigator feels that there is scope for further work in this virgin field of research.

1. This research has demonstrated only a fraction of the potential power of the need-press theory to extend to educational-psychological theory and to throw light on practical educational problems. A more comprehensive study will take into account more environmental variables, will employ a wider range of psychological variables, and will try to study their best combination to understand and predict student involvement in studies.

2. It is an accepted fact that human beings differ widely both individually and culturally, in the strength of psychological needs and in the motives and goals through which they are met. Thus in one person, achievement needs may be the most powerful whereas in another need for affiliation may be the most strong. In this investigation it has not been possible to study the strength of different needs in different students. It is suggested that a study may be taken up in this area and symptom profiles of various needs may be prepared.

3. A comparative study may be made utilizing both, a single basic dominant, integrating motive, as proposed by Patterson (1964) and multiple motives and then the validity of both the approaches may be established.

4. Human beings constantly strive to satisfy their biological, psychological and social needs. Thwarting of these needs often produces conflict and frustration. With the state of frustration, different individuals give different types of reactions as withdrawal, aggression, displacement, regression, repression etc. In the present study also there are students whose needs do not seem to be fulfilled by studies (those who have low involvement in studies). It will be worthwhile to study the reactions of these students and compare them with those of the high involvement students.

5. There is a low and significant correlation between the level of aspiration and student involvement in studies. It seems that these two should be positively related. Perhaps the measure of level of aspiration used in this study is not a valid tool for the sample. Attempts should be made to use a more valid measure of level of aspiration in future studies.

6. The CPP Questionnaire as used in the present study was designed to measure the characteristics that are preferred by parents in a high school student. The students have rated their own conceptualizing about parents. An attempt should be made to collect the preferences of parents for certain characteristics in a high school student from parents themselves.

7. Study conducted by Coleman (1961) to investigate the values of girls and boys showed that to be accepted among the leading crowds or elites boys needed personality, reputation and athletic ability, while girls needed personality, reputation and friendliness. High scholastic achievement was rated low by both the groups. Hughes, Backer and Geer (1962) and Ringness (1967) report similar findings in the American context. Research may be done on students' values in the Indian context and comparison be made of both the groups of students, those who rate scholastic achievement high and those who rate it low.

8. Corwin (1966) has demonstrated relationship between organizational characteristics in school and the professionalism of its teaching staff. Fraser (1967) showed that school characteristics predicted teacher happiness and commitment. It is needed to extend such intensive research into the teachers involvement and their satisfaction also. In this investigation only a very few school characteristics have been studied.

9. It would be interesting to place the students in the two classified groups using the discriminant function coefficients and their raw scores and find out the percent of success and prediction. This is beyond the scope of the present work.

10. In the present study, items of the study involvement inventory have been selected on the basis of judgment of experts. Studies may be done with another inventory developed on the basis of factor scores.

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APPENDIX-I

CODING PLAN FOR CARD PUNCHING

CARD ONE

Col. No.	Number of Digits	Name of Variable	Coding Range	Type of Variable
1-3	3	Serial number of student	1-600	—
4	1	Card number*	1	—
5, 6	2	Identification number of school	1-15	—
7	4	Management of school	1-4	Background variable
8	3	Type of school (sex-wise)	1-3	—do—
9	2	Geographical location of school	1, 2	—do—
10	1	Sex of subject	1, 2	—do—
11	1	Birth-order	1-3	—do—
12	1	Caste	1, 2	—do—
13, 14	2	Socio-economic status (raw score)	14-71	—do—

15, 16	2	Involvement in studies (score)	16—76	Criterion Variable
17, 18	2	Intelligence	0—31	Psychological variable
19—21	3	Level of aspiration	—91 — +77	—do—
25, 26	2	Social desirability (total score)	10—38	—do—
35, 36	2	Factor A	3—16	Psychological variable
37	1	Factor B	1—7	—do—
38, 39	2	Factor C	0—16	—do—
40, 41	2	Factor D	0—16	—do—
42, 43	2	Factor E	0—14	—do—
44, 45	2	Factor F	3—16	—do—
46, 47	2	Factor G	3—16	—do—
48, 49	2	Factor H	0—16	—do—
50, 51	2	Factor I	1—15	—do—
52, 53	2	Factor J	1—13	—do—
54, 55	2	Factor O	0—16	—do—
56, 57	2	Factor Q2	2—14	—do—
58, 59	2	Factor Q3	3—16	—do—
60, 61	2	Factor Q4	0—16	—do—
62, 63	2	CPP (total score)	3—15	—do—

*—There are two cards for each student.

CARD TWO

Col. No.	Number of Digits	Name of Variable	Coding Range	Type of Variable
1—3	3	Serial number of student	1—600	—
4	1	Card number	2	—
5, 6	2	Identification number of school	1—15	—
7, 8	2	English (class X)	33—76	Scholastic achievement variable
9, 10	2	Maths. (class X)	33—75	—do—
11, 12	2	Hindi (class X)	15—73	—do—
13, 14	2	Soc. Studies (class X)	24—78	—do—
15, 16	2	Gen. Science (class X)	32—81	—do—
17, 18	2	Total Marks (class X)	29—71	—do—
19, 20	2	English (class IX)	20—80	Scholastic achievement variable
21, 22	2	Maths (class IX)	20—86	—do—
23, 24	2	Hindi (class IX)	23—86	—do—
25, 26	2	Soc. Studies (class IX)	16—86	—do—
27, 28	2	Gen. Science (class IX)	29—83	—do—
29, 30	2	Total Marks (class IX)	31—89	—do—

APPENDIX-II

STUDY INVOLVEMENT INVENTORY (S.I.I.)

INSTRUCTIONS

“There are 40 statements in this inventory. These statements are related to the teaching-learning situation. You have to read each statement and express your views on it. Read each statement carefully and think what is your view about it, then respond to the each statement in any of these alternatives on your right hand side. You will find ‘Yes’ ‘Undecided’ ‘No’ cells against the number of each statement. If you agree with the statement put a ‘×’ (cross mark) with first cell, if you disagree with it put the ‘×’ with the third cell and if you are not able to decide put the ‘×’ cross mark with the middle-cell.

- (i) Life is meaningless without education,
- (ii) It is difficult to get good marks.

	Yes	Undecided	No
X	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>	X <input type="checkbox"/>

Therefore in the first example (i) a cross ‘×’ has been put in the first cell indicating yes, similarly for statement (ii) ‘No’ response is crossed out with the third cell indicating no response thus, it is clear from these examples that there is no right or wrong answer. Whatever is correct for you is correct answer.

There is no time limit for the inventory, but try to finish it quickly. Answer sincerely and without any hesitation. Do not try to think which answer is desirable. Respond to each statement. Do not leave any statement unanswered. If you have any more problems, please feel free to ask.

Now start,

	Yes	Undecided	No
1. One has to work very hard to achieve success.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. I study because my parents want me to study.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Teachers should consult students about homework.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. I like teachers very much.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. I am proud of my marks.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. I always like to be in the school.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7. Teachers seem to be very arrogant.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8. I often dream that I have failed.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9. I feel pity on boys who are weak in studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10. If I do not understand lesson I ask somebody.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11. I can do anything for studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
12. I like those students who study.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13. Inspite of my parents insistence I do not study.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14. Teachers know a great deal about home work.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
15. It is my strong desire to get prizes for studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
16. My books are always arranged properly at one place.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
17. I enjoy very much when some students irritate teachers.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
18. I find arithmetic sums very difficult.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
19. I should pay attention to boys who are weak in studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
20. Most of my friends help me in studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
21. I hope to be a great man when I grow up.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
22. I am proud of my school.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
23. One feels happy without studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
24. Teachers in my school have good character.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
25. Success begets praise from all.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
26. One should finish work in time.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
27. It is foolish to solve mathematical problems.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

	Yes	Undecided	No
28. I feel ashamed if I am not able to answer a question in my class.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
29. Most of my friends are weak in studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
30. My brothers and sisters help me in studies.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
31. Goal of life is to study.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
32. I like all my class fellows.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
33. Homework should not be given.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
34. Teachers work is full of responsibility.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
35. Only educated persons get respect in the society.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
36. Homework should be finished in time.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
37. No student can be happy in school.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
38. I feel ashamed what I lag behind in the class.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
39. I help my friends in solving their educational problems.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
40. I like those teachers who help us.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

AUTHOR INDEX

Aaroon, P. G.	26	De, B	25, 26, 29, 85
Adams, S.	29, 53	Deci, E. L.	3, 5, 14, 17, 18, 19, 56, 89
Akhtar, S. S.	26	Dember, W. W.	21
Adler, A.	21	Dembo, T.	27
Allport, G. W.	13	Demos, G. D.	32
Anderson, L. W.	2, 53	Desai, D. B.	20, 23, 27
Arnold, M.	16	Duncan, B.	29
Atkinson, J. W.	5, 13, 14, 16, 17, 19, 21, 92, 96,	Duncan, O. D.	29
Babladelis, G.	29	Eagley, A. H.	52
Backer H. S.	102	Edwards, A. L.	28, 40
Ball, J.	54	Elton, C. F.	26
Barial, R. N. P.	23, 54, 32, 78	Entwistle, N. J.	23
Bassett, G. W.	31	Eugene, G. U.	31, 53, 78
Baumarind, D.	29	Evans, C. M.	25
Berclay, J.	73	Feather, N. T.	13
Berlyne, D. F.	1, 12, 57	Featherman, D. L.	29
Bhargava, M.	41	Ferguson, G. A.	58
Bhatnagar, A.	31, 42, 69	Festinger, L.	13
Biddle, B. Jr.	22	Frank, J.	27
Bock, R. D.	48	Fraser, G. S.	102
Bowman, P. H.	26	Friedman, G. A.	30
Brams, J. T.	78	French, E. G.	27, 84
Burnett, C. A.	26	Fruchter, B.	48, 49
Campbell, W. J.	31	Garrett, H. E.	47
Cantril, H.	29, 50, 51, 54	Gauld, R.	27
Carroll, R. B.	53, 54	Gaur, J. S.	22, 61
Cattell, A. K. S.	36	Geer, B.	102
Cattell, R. B.	33, 36, 37,	Gibson, J. J.	41
Chaudhary, N.	20, 23	Gill, L. J.	73
Chattopadhyay, S. W.	28	Gokulnathan, P. P.	20, 23
Chitra, S. L.	21, 22	Goldenson, R. M.	52
Chopra, M. N.	21	Goldstein, L. D.	26
Coleman, J. S.	82, 102	Goodenough, E. W.	77
Cooley, W. W.	59	Gordon, M. N.	43
Corwin, R. G.	102	Gordon, J. E.	1
Cronback, L. J.	28	Gordan, L. V.	25
D' Andrade	29	Gough, H. G.	43
		Griffin, R. S.	54

Guilford, J. P.	49	Lynn, R.	25
Gupta, K.	22, 73	Manis, M.	52
Guthrie, G. M.	25	Maslow, A. H.	5, 11, 12, 27
Haas, K.	32	Mc Clelland, D. C.	13, 21, 29, 30, 85
Hall, C. S.	7	Mc Keel Jr. J. J.	25, 78
Harman, H. H.	48	Mehrotra, K. K.	37, 39
Hayes, R. G.	23, 63	Mehta, P.	22, 23, 24, 31, 63
Hebb, D. O.	1, 12, 13	Middleton, G.	25
Heilburn Jr. A. B.	26, 69	Mishra, P.	40
Holland, J. L.	64	Mitra, S. K.	22
Hoppe, F.	27	Morrison, H. C.	53
Horner, M. S.	13	Moss, H. A.	30
House, W. C.	20	Mubayi, G.	20
Hovland, C. I.	52	Mukherjee, B. N.	21, 49, 59, 85
Hughes, E. C.	102	Munz, D. C.	23
Hunt, J. McV.	13, 92	Murray, H. A.	2, 5, 6, 10, 56
Irwin, F. W.	17, 19	Muthayya, B. C.	27
Jagbir Kaur	23	Newman, H. L. Jr.	25
Jalota, S.	43	Norman, R. D.	82
Jawa, S.	28	Obuchowski, K.	11
Jha, M.	25, 85	Overall, J. E.	49
Kagan, J.	18, 30	Ozeelik, D. A.	53
Kaiser, H. F.	48	Pal, S. K.	31
Kanade, H. M.	23, 24	Pandey, R. N.	43
Kapoor, S. D.	37, 39, 43	Parikh, P. A.	20, 24
Karabenick, S. A.	21	Patterson, C. H.	101
Katz, I.	70	Pearson, K.	58
Kelman, H. C.	73	Pedhazur, E. J.	49
Kendall, M. G.	48	Perkins, D. S.	55
Kerlinger, F. N.	49	Porter, L. W.	25
Khan, A.	26	Query, W. T.	23, 25
Kish, L.	45	Query, J. M.	23, 25
Klett, C. J.	49	Rajeshwari, S.	27
Kluckhohn, C.	11	Rao, S.	36
Koch, S.	1, 12	Ringness, T. A.	102
Kohn, M. L.	43	Rogers, C. R.	13
Kumar, K.	23, 28	Rosen, B. C.	21, 29, 30
Kuppuswami, B.	43	Roth Kopf, E. Z.	53
Lawler, III, E. E.	25	Rotter, J. B.	27
Leeper, R. W.	16	Rufus, D. W.	55
Levy, L. H.	3, 17	Russell, I. L.	31
Lewin, K.	2, 3, 14, 16, 27	Sampson, E. E.	21
Lindzey, G.	7	Saxena, P. C.	31
Locke, E. A.	6, 19	Schachter, S.	21
Lohnes, P. R.	59		
Lounsbury, J. W.	54		
Lewell, E. L.	30		
Lum, M. K. H.	31		

Schuldt, W. J.	94	Staats, A. W.	78
Scott, W. E. (Jr.)	89	Stavros, D.	24, 63
Seidel, H. E.	24, 63	Strong, E. K.	47
Sewell, W. H.	24	Sutton, R. S.	30, 78
Shah, M. A.	41	Tamhankar, V. S.	24, 31
Shah, V. P.	24	Taylor, D. W.	18
Shambhoo Priya	29	Thistlethwaite, D. L.	64
Sharma, B. R.	23, 24	Thresher, R. A.	31
Shaw, M. C.	32	Tolman, E. O.	14, 16
Sherif, M.	29, 50, 51, 54	Tornatzky,	54
Sherif, C. W.	29, 51	Trivedi, G.	43
Siddiqi, M. M.	26	Tuel, J. K.	25
Siegel, S.	58	Tyler, R. W.	53
Simon, H. A.	17	Uhlinger, C. A.	25
Singh, B. N. K.	30, 78	Vandev Meer, H. C.	28
Singh, R. N.	36	Varma, M.	31, 53
Sinha, D. N.	20, 24, 26, 32	Vroom, V. H.	16, 17
Skinner, B. F.	78	Weiner, B.	3
Smart, J. C.	26	Wheat, H. G.	53
Smee, P. G.	78, 94	White, R. W.	3
Spence, J. T.	20	Winterbottom, M. R.	30
Spilka, B.	73	Wolf, M. G.	27
Spolyar, L. J.	32	Wood, D. A.	59
Srivastava, A. K.	31	Woodworth, R. S.	13
Stephens, M. W.	25	Wurston, R.	25
		Wyer, R. S. Jr.	18
		Yanoff, J. M.	54

SUBJECT INDEX

Antecedent Stimuli	3	Factor Analysis	48
Background variables	20, 33, 43, 44, 45, 60, 64	Findings	98
Behaviour	1, 2, 3	First generation learners	62
-goal directed	17	Functional autonomy	13
-multiple determinants of	12	Geographical location	23, 67
Behaviour Primacy Theory	13	Incongruity Theory	13
Birth order	21, 63, 65	Intelligence	84
Caste	21, 66	Intrinsic motivation	12
Characteristics preferred by parents.	29, 40	-Atkinson' theory of	14, 16
Coefficient of Multiple Determination	49	-Cognitive theory of	3, 17
Cognitive Dissonance Theory	13	-Deci's theory of	12, 13
Cognitive processing	3	-theories of	12, 13
Chi-square test	58	Involvement	1
Conclusion	98	-in education	52
Correlation	58	-and need satisfaction	55
-Partial	49, 59,	-as participation	54
Culture Fair Intelligence Scale III	36	Jr. Sr. H. S. P. Q.	37
-reliability of	36	-fourteen factors of	37, 38, 39
-validity of	37	-reliability of	39
Discriminant Function Analysis	47, 49, 59	-validity of	39
Ego involvement	50, 51, 52,	Level of aspiration	27
Explained Variance		Level of aspiration measure	41
Decomposition Analy- sis	49	-norms of	42
		-reliability of	41
		-validity of	41
		Management of School	22, 63, 66
		Mastlow's theory	11
		Mediating cognitive events	3
		Methodology	38
		Motivation	1

- extrinsic 1
- intrinsic 1, 56
- Murray's Personology 5
- needs 2, 6
- definition of 6
- fusion of 10
- hierarchy of 10, 11, 27
- importance of 11
- primary 10
- satisfaction of 94
- secondary 10
- taxonomy of 2
- Personality character-istics 24
- Press 10
- alpha 11
- beta 11
- Procedure 45
- Psychological variables 24, 33, 46, 67, 68, 70, 71, 72, 74, 75
- Rewards 17, 19
- extrinsic 19
- intrinsic 19
- sample 44
- satisfaction 17, 18, 19
- Sex 20, 65
- Scholastic achievement 30, 44, 46, 77, 79, 80, 81, 82, 83,
- Social desirability 28
- Social desirability scale 40
- Socio-economic status 23, 24
- Socio-economic status scale 43
- reliability of 43
- validity of 43
- Statistical analysis 46
- bivariate analysis 47, 58
- multivariate analysis 47, 59
- univariate analysis 47, 58
- Step-wise multiple regres-sion analysis 49, 59
- Student involvement in studies 3, 4, 20
- factors related to 20
- model of 95
- prediction of 85
- Study involvement in-ventory 42
- norms of 42
- reliability of 42
- validity of 42
- Suggestions 98, 101
- Thought processes 17
- Type of school 22, 66
- Valence 3
- negative 3
- positive 3

ERRATA

The following misprints have occurred :

Page	Line	for	Read.
16	20	Leaper	Leeper
22	4	is	has
22	28	emotionaly	emotionally
14	33	included	include
16	35	<i>success increases</i>	<i>of success increases</i>
20	2	a numbering	a number of
25	20	responsibility	responsibility
31	25	Started	Stated
32	19	Hass	Haas
32	26	as given in part I of this chapter	as given in this chapter
34	24	Student's	Students
34	29	Significant achievement difference	Significant difference
36	21	Metrics	Matrices
37	4	Crorelation	correlation
38	1	low	lower
39	5	Conffet	Conflict
40	25	Misra	Mishra
41	15	aspiastion	aspiration
41	15	1 C.M.	1 c.m.
52	16	the extent	to the extent
55	20	indentified	identified
56	3	individuals	individual
58	22	Chi Square Ist	Chi square test of association
62	1	Thee correlation in Table 6.2 show that none Scheduled Caste	the correlation in table 6.2 shows that non scheduled caste

70	11	Psychological	Psychological
73	16	Difference	Difference
		Variables	Variables
74	2&3	Psychological	Psychological
		Variables Mean and	Variables Mean
		S.D. of the Low involvement	and S.D. of the
		girls and low Involvement	high Involvement
		boys and T-value	and Low Involvement
			Girls and
			t value
78	27	Barial (1966) and	Barial (1966) and
		Eugene (1976),	Eugene (1976), for
		example found.	example, found
77	20	r with IIs	r with IIS
89	7	three sets of variable	Three Sets of
			variables
89	18	Show	shown
107	7	Eva unit	EVG Unit
108	22	Monogrph	Monograph
108	31	&	a
123	4	Number	Number of Digits
		Digits	
126	16-17	Whatever is correct	Whatever is
		for you is correct	correct for you is
		answer	the correct answer.
127	12	Understand lesson	Understand a
			lesson
127	15	Parents	Parents'
128	1	undecided	undecided.
128	14	What is lag	When I lag
		behind	behind.

SALES REPORT

Period 6

Year ending 31st December, 19..

Item of Sale	This period			This year to date			Last year to date		
	Budget	Actual	Variance	Budget	Actual	Variance	Budget	Actual	Variance
Product A									
Product B									
Product C									
Totals									

Variance analysis:

and the preparation and issue of reports. Such a document can be called the *budget programme*.

FLEXIBLE BUDGETS

The system so far described is the fixed budget, *i.e.*, a budget based on a specified amount and mix of sales. Therefore, if the mixture of sales or the level of sales differs from those anticipated, there will be variances in the budgeted figures and this will make the true assessment of variances difficult. A number of fixed budgets postulating different sales levels and mixtures may in a few cases be satisfactory. When this method is used the budgeted figures of the sales budget nearest to the actual figures is taken for comparison and the extraction of variances. Alternatively, the information is extracted by means of interpolation.

A fully flexible system of budgetary control is obtainable by the adoption of flexible budgets. This system is based on the theory that *a change in volume or sales mix will directly affect the absorption of fixed overheads*. Overheads are therefore divided into variable overheads and fixed overheads. Direct (material, labour and expenses) and variable overheads are allocated to cost centres and ultimately expressed in terms of a unit of output or time. Thus, no matter how the sales volume or sales mix differs from what was anticipated, the budgeted figures relating to those sales can be compiled from the units sold in the period. Also, if the variance due to the change in

volume or sales mix is first extracted from the fixed overheads, the balance can be compared with the budgeted fixed overheads. Accordingly, no matter how the sales volume or sales mix differs from the estimated sales a true comparison of actual and budgeted figures can be made.

CHAPTER THIRTEEN

*Management Accounting—II:**Planning of Finance*

PLANNING FINANCE

CAPITAL REQUIREMENTS

The capital requirements of a business can be divided into two main parts. First there is the capital that will be used to purchase the assets required to produce the undertaking's sales items, such as buildings, plant, equipment, etc. This capital is invested in these assets permanently and is therefore *fixed capital*. Secondly, capital will be required to purchase raw materials for production, to pay wages, salaries, etc., and many other expenses that have to be met. This is *circulating and working capital*.

Although the capital is divided into two parts, the parts are inter-related and, depending on the nature of the business, there must be a satisfactory ratio between the two. In some industries very little capital equipment is necessary while in others expensive capital equipment is required. The amount of fixed capital locked up in the undertaking is considered to be an investment; it participates in the earning of profit. The profit so earned will immediately increase the circulating capital, but in the long term it will also be partly used for the acquisition of further capital equipment. Depreciation provided on a fixed asset will temporarily increase working capital until such time as it is used to replace the asset. Thus, there is a constant cycle between fixed and circulating capital.

Fixed Assets. The importance of fixed assets is that they earn profit and therefore they must be kept in a state to earn maximum profit. Capital available for investment in fixed assets is in the first instance provided out of the funds available to start the undertaking. Later, renewals of equipment and additional equipment are normally provided out of profits earned and set aside for the purpose. Obsolete or worn-out plant cannot earn maximum profits and must be replaced. Sometimes it is better to replace plant which is not obsolete or worn out by other plant. This is considered later in this chapter.

FLOATING (OR CIRCULATING CAPITAL)

In the first instance finance is required to buy raw materials, to pay

wages and to meet other expenses. In due course the raw material will be converted into stock, the stock will be sold and as most of it will be sold on credit, debtors will be created. Subsequently, cash will be received from the debtors and used to pay creditors. The amount flowing in this cycle should be ever-increasing because more should be received for the finished product than it cost to make. If this increase is not continuous, the undertaking is stagnating and will not expand. This cycle of events is of major importance to the prosperity of the undertaking.

The efficiency of the cycle also depends upon a proper balance of the constituent items. Thus, if stock is allowed to pile up beyond the limit necessary to satisfy sales, or if obsolete or very slow-moving stock is held, money will be locked up in stock that otherwise would be available to finance greater production. Similarly, if debtors are given too long a settlement period or debts are allowed to be outstanding for some time, money is lying idle. In both cases floating capital is not being used efficiently.

WORKING CAPITAL

Working capital is the *excess of current assets over current liabilities*. On the inception of an undertaking the amount of working capital required must be ascertained and an amount added for contingencies. Afterwards the profit earned should provide for an ever-increasing amount of working capital. Working capital in its turn will be used to finance some plant expansion and to meet the additional costs of increased production and this in turn will increase the working capital increments. *The undertaking should always be growing*. If working capital is insufficient, growth will be restricted, for the resources necessary to increase production will not be available and if working capital exceeds requirements there will be a waste of capital unless the surplus can be invested to earn interest, because all capital should earn money.

Calculation of the amount of fixed capital required presents little difficulty. It is more difficult to estimate the amount of working capital that will be required. The method of finding this amount is shown on the next page.

From the following estimates the working capital required is to be ascertained.

	£
Estimated Sales	100,000
Cost of sales:	
Direct material	25,000
Direct labour	30,000
Variable overhead	15,000
Fixed overhead	10,000
Required for contingencies	20,000

Raw material stock will be held two weeks before entering production.

Finished stocks will be held three weeks before sale.

Production of finished stock will take four weeks.

Suppliers will extend four weeks' credit.

Customers will require six weeks' credit.

Overheads will accrue evenly over the period.

All material used enters work-in-progress at the commencement.

	£
Costs per £ of sales:	
Direct material	0.25
Direct labour	0.30
Variable overhead	0.15
Fixed overhead	0.10
	<hr/>
	0.80
Profit	0.20
	<hr/>
	<u>1.00</u>

WORKING CAPITAL REQUIRED

		£
Stock of raw materials	$\frac{5}{52} \times \frac{5}{20} \times 100,000$	962
Work-in-progress:		
Material	$\frac{4}{52} \times \frac{5}{20} \times 100,000$	1,923
Labour	$\frac{1}{2} \times \frac{4}{52} \times \frac{3}{10} \times 100,000$	1,154
Variable overhead	$\frac{1}{2} \times \frac{4}{52} \times \frac{3}{20} \times 100,000$	577
Stock of finished goods	$\frac{3}{52} \times \frac{8}{10} \times 100,000$	4,615
Debtors:	$\frac{6}{52} \times 100,000$	11,538
Cash for contingencies		<u>20,000</u>
		40,769
Less Creditors	$\frac{4}{52} \times \frac{5}{20} \times 100,000$	<u>1,923</u>
Total Working Capital Required		<u>£38,846</u>

Materials enter work-in-progress at the commencement but labour cost and overhead accrue evenly over the period. Accordingly at any one period the labour cost and overhead content of the value of

work-in-progress will be the average of one half of the labour cost and overhead applicable to a completed unit.

LIQUID CAPITAL

Not all the working capital is liquid. It takes time for stocks and work-in-progress to turn into cash or near-cash. Thus the liquid resources consist of debtors, bank balances and cash-in-hand and any temporary investments that can be turned into money at short notice. These are *liquid assets*. Creditors and loans maturing at an early date are *liquid liabilities*. If the liquid assets of an undertaking are insufficient to satisfy these "liquid" liabilities, financial difficulties are imminent. *The liquidity of the concern is its ability to meet these liabilities at any given time.*

It is possible that while the working capital seems to be adequate, liquidity is far from adequate. This position arises because the company has accepted more work than it can finance; it has not the liquid resources to finance the labour and materials required for the additional work until cash is received from the sale of the completed work and apparently it has been unable to obtain temporary accommodation from the bank or by other short-term borrowings. Wages must be paid, so the suppliers of materials have to suffer and they are not willing to supply more materials until their debts are settled. A serious position arises. It is wisest, therefore, to refuse orders that cannot be adequately financed.

A recurring or medium-term shortage is usually overcome by obtaining a bank overdraft, but a continued shortage of liquid capital indicates the need for additional capital. This can be brought into the business either by long-term borrowing or by the issue of additional share capital. Before such borrowings are considered, however, internal matters should be investigated carefully for additional cash resources may be obtained in a number of ways. Lengthening the time taken to pay creditors is tantamount to an addition to cash; usually this cannot be done without impairing supplies and all that can be done in this respect is to forgo discount for prompt payment. If the period of credit allowed to debtors can be shortened, more cash will be available but if the period cannot be shortened, larger discount may be offered if accounts are settled within seven days. Usually stock is a likely source; if it can be trimmed down by careful examination more cash may become available.

To avoid running into trouble, a cash forecast is normally made to determine the *expected cash position* over the next three to six months. The cash forecast is approached in a similar manner to the cash budget in budgetary control as shown in the following example.

STATEMENT OF ESTIMATED MONTHLY CASH POSITION
for Six Months ending 30th June, 19 . .

	Jan.	Feb.	March	April	May	June	Out-standings
	£	£	£	£	£	£	£
Receipts:							
Debtors	17,000		25,000	25,000	25,000	25,000	
Sale of Plant	—		—	—	15,000	—	50,000
Payments:							
Trade Creditors	12,750	25,000	20,000	20,000	20,000	20,000	20,000
Wages and Salaries	1,500	1,500	1,500	1,500	1,500	1,500	—
Expenses	1,000	950	950	950	950	950	950
Dividend						1,200	—
	£15,250	£27,450	£22,450	£22,450	£22,450	£23,450	£20,950
Surplus	1,750		2,550	2,550	17,550	1,350	
Deficiency		27,450					
Balance b/f	+ 7,500	+ 9,250	- 18,200	- 15,650	- 13,100	+ 4,450	
Balance c/f	+ 9,250	- 18,200	- 15,650	- 13,100	+ 4,450	+ 5,800	

Owing to adverse trading conditions a company considers it wise to change its sales pattern and give extended credit terms to customers. In order to approach its bank for temporary finance as and when required, it needs to know how much its greatest indebtedness to the bank will be and when the accommodation will be required. The period under consideration is a six months period to 30th June.

At 31st December the company owes £12,750 to trade creditors and a further £1,000 in respect of outstanding expenses. Debts owing to the company are £17,000 and there is a balance at the bank of £7,500.

As from the 1st January sales are expected to increase from £17,000 to £25,000 per month. The rate of profit sales and direct cost will be reduced from 25 to 20 per cent. Customers' accounts are settled by the end of the month following the month of delivery but an additional month's credit is being allowed as from 1st January sales.

The credit period obtained for supplies (direct costs) remains unchanged and payment is made by the end of the month following the month of delivery.

Stocks are to be increased by £5,000 in January and will remain at that level throughout the period.

Salaries of £1,500 per month are to be paid in the month to which they relate.

Expenses of an estimated £950 per month are to be paid in the month following that in which they were incurred.

A half-year's preference dividend of £1,200 is to be paid in June.

It is expected that surplus plant can be sold for £15,000 and that the proceeds will be received in May. *The information required is ascertainable from the statement on the previous page.*

The maximum facilities required will be £18,200 in February but the overdraft will be liquidated during the following May.

OVER-CAPITALISATION

The sign of over-capitalisation is usually the inability of the company's profits to provide an adequate return on the capital invested. It may be due to an over-estimate of capital required, or of trading potential, or a recession in trading.

If over-capitalisation is the result of an over-estimate of capital requirements, there may be no adverse effects. Management will have reserves to meet setbacks and finance will already be available for expansion and improvement. There may be some inefficiency because management will be less eager to search for economies. If the additional finance cannot earn an adequate rate of interest it will be wasted.

An over-estimate of trading or a recession can have bad effects. Management will try to increase sales and may cut selling prices and extend the credit period offered to customers. This would no doubt involve them in severe competition. The opposite course may be adopted, that of increasing the sales price and lowering the quality of the product.

No matter what the cause, a low rate of dividend will adversely affect the stock exchange price of the undertaking's equities. This will lead to lack of confidence in the company and suppliers may restrict credit.

UNDER-CAPITALISATION

In this case the profits show a high return on capital invested. This may be due to an under-estimation of the capital requirements of the undertaking and will have the effect of restricting the undertaking's ability to expand; it may lead to inadequate working capital and inability to buy in economic quantities or to accept cash discounts, etc. If it results from an under-estimation of profits, then the company is more efficient than was anticipated and should have little difficulty in getting additional capital from the market or in obtaining credit. Its prosperity might, however, have adverse repercussions: there may be labour troubles as workers may demand a greater share in profits and customers may seek price reductions and take extended credit.

OBTAINING FINANCE

The method of obtaining finance depends upon the nature of the undertaking. Sole traders and partnerships usually obtain finance from their own savings or those of their friends and relations. A company must obtain its finance by the issue of shares and usually borrowings by way of debentures. A private limited company is often the outcome of the growth of a sole trader's business or a partnership into a proprietary company and shares will be issued for the value of the assets transferred. A public company or a private company going public must persuade the public at large to invest money in the purchase of shares. Much of this finance comes from finance companies, insurance companies, building societies and other institutions with cash reserves held for investment.

REQUIREMENTS OF AN INVESTOR

Unless he is wholly speculative or wholly unspeculative an investor will wish to spread his risk; that is, he will wish to arrange his investments so that part of his portfolio will give him *security of capital* and the other part will be invested to give a *good yield*, though at the risk of his capital. He may have temporary funds for investment or he may wish to have part of his funds frequently maturing so that he has cash resources for further investment.

Temporary funds are usually invested for security in deposit accounts at banks, where they can be converted at short notice.

A continual turnover of cash is normally achieved by choosing dated securities; the amount receivable on encashment and the date it will be received are known. Such investments are usually found in government securities and securities of counties and cities but suitably dated redeemable preference stock or loan stock of a public company may be available.

An investor for a longer term who requires some security of capital will usually look for investment in limited companies. If he requires the greatest security of capital he will take up debentures but he must then expect a low interest rate. There will be slightly more risk to capital if he invests in preference shares; dividends on these shares will be preferred to ordinary dividends. Thus the interest rate the preference shareholder can expect will be more than he would receive for debentures but less than on ordinary shares.

Ordinary shares carry most risk as regards capital and dividends but they are the first to benefit by increased returns and capital increments. Because of the risk involved, however, the investor requires a greater return on his money, the return being based on his assessment of the risk not only to capital but also to dividends. Risk

depends largely on the capital structure of the company. This matter is dealt with later under the heading "capital gearing".

A company declares its dividends and interest as a rate based upon the nominal value of its securities and this rate is no indication in itself of the return to the investor. The investor's return is the amount received expressed as a return on the price he has had to pay for the security. This is called the "yield" from the investment; thus, if a company pays 6 per cent on a £1 preference share for which the purchaser had to pay £2, the yield to him is only 3 per cent. The yield is calculated by the formula:

$$\frac{\text{Nominal Value}}{\text{Cost}} \times \frac{\text{Rate per cent}}{\text{of dividend}} = \text{Yield}$$

ISSUE SHARES/STOCK PRICES

Shares are quoted at a price per share. Stock is usually quoted at a price per £100 of stock but is sometimes broken down to stock units of £1, 50p or 25p and is then quoted at a price per stock unit.

From the previous paragraphs it will be appreciated that the price at which a share must be issued if the issue is to be successful is the price that will give the investor the yield he expects. To achieve this yield there are two manipulative factors: the *rate of dividend* and the *issue price*. It is not always possible to get the correct yield by using the first factor—the dividend rate—alone. An investor in debentures to be issued may require a 7 per cent yield but the company may feel that a dividend rate of 7 per cent would strain their profits unduly. They would then need to bring in the second factor, the issue price. Assuming the company thought a 5½ per cent rate of interest was all they could afford, they could achieve the object of a 7 per cent yield by issuing the debentures at a discount. By use of the yield formula the price of issue to give a 7 per cent yield would be 78½p per £1 debenture, calculated as follows:

$$\frac{\text{Nominal Value} \times \text{Interest}}{\text{Yield}} = \text{Market Value}$$

$$\frac{£1 \times 5\frac{1}{2}}{7} = £0.78\frac{1}{2}$$

Conversely the rate of dividend earned by the ordinary shares may require an issue at a premium. If the investor required a 10 per cent yield on an ordinary share on which it was anticipated 15 per cent would be paid, the £1 share would be issued at a premium of 50p per share, i.e., the price of the share would be £1.50.

CAPITAL AND INTEREST COVER

When assessing the risk at which his investment stands, an investor usually determines its *cover* as to both capital and income. The cover is expressed as *the number of times his capital or income is covered by the resources of the company*.

Assume the following figures for a company:

Issued Capital: 6 per cent First Preference Stock	£
5½ " " Second " "	20,000
£1 Ordinary Shares	20,000
Loans 4½ per cent Debenture Stock	50,000
	10,000
Net Tangible Assets before deducting Debenture Stock	170,000
Profit before charging taxation and debenture interest	15,250

The capital cover is as follows:

Debenture-holder:	$\frac{170,000}{10,000}$	= 17 times
First Preference shareholder:	$\frac{170,000 - 10,000}{20,000}$	= 8 times
Second Preference shareholder:	$\frac{170,000 - 30,000}{20,000}$	= 7 times
Ordinary shareholder	$\frac{170,000 - 50,000}{50,000}$	= 2.4 times

The interest cover is as follows:

Debenture-holder	$\frac{15,250}{450}$	= 35 times
First Preference shareholder	$\frac{15,250 - 450}{1,200}$	= 12.3 times
Second Preference shareholder	$\frac{15,250 - 1,650}{1,100}$	= 12.4 times

The remaining interest of £12,500 is equivalent to 25 per cent on the ordinary share capital and should sustain a dividend of 15 per cent.

Many things affect the investing public's preference as to the class of share they are looking for at any one time, *e.g.*, political unrest at home or abroad, labour troubles in a particular industry and Government restrictions. Care needs to be exercised in timing when the issue is to be offered to the public. Experts in this field are finance

houses and issuing houses which usually assist in any issue that is to be made.

WHAT CAPITAL TO ISSUE

Debentures are not usually issued as an instrument of perpetual capital. They are generally issued only to finance the company over a period during which profits can be earned and set aside to take their place. This may be long-term, 50 years, or short-term, 10 years. As their interest rate is lower than that on issued share capital, debentures are a cheap method of borrowing but interest is payable whether or not profits are earned and this may lead to embarrassment in the early years. Also, rights are usually attached giving debenture-holders power to seize the assets on which their debentures are secured if the interest is more than six months in arrear.

The amount of capital raised in this way is usually limited by the Articles of Association of the company. Borrowing by debentures may restrict the amount that can be borrowed from the bank to finance temporary requirements. A debenture charging the whole assets of the company is often given to the bank as security for a bank overdraft which may be of a long-term nature. An advantage of debentures is that they can be redeemed out of profits set aside for the purpose as well as by the issue of fresh debentures, whereas preference share capital if not redeemed out of profits can be redeemed only out of the proceeds of a fresh capital issue.

Preference shares do not charge the assets of the company; dividends on them are payable only when profits are available. The terms of issue can be varied quite considerably. They can provide for arrears of dividend to be made good before current dividends are paid; these are *cumulative preference shares* and all preference shares are deemed to be cumulative unless stated to be otherwise. If arrears of dividends are not to be made good, they are *non-cumulative preference shares*. They may be entitled to share in profits over and above their fixed interest rate after provision has been made for a stated dividend on the ordinary share capital; these are *participating preference shares*. Usually on a winding-up, these shares are preferential up to their par value. Provision is sometimes made for them to participate in any surplus available after repayment at par of the ordinary share capital.

Ordinary shares, carrying greatest risk, rank for repayment of capital and for payment of dividends after debenture holders and preference shareholders. They have, however, the advantage that they are the first to share in the prosperity of the company by way of greater dividends or capital increments.

Shares of no par value are not sanctioned by law. In favour of the issue of such shares, it is argued that confusion is caused in the mind of the investor because the rate of dividend is expressed on the par value of the security and gives no indication of the rate of interest received by the investor on the money he paid for the shares. Furthermore, once the shares have been issued their value to the investor is more or less than the par value and so par value ceases to be significant. If shares of no par value were issued, the dividend would be expressed in terms of cash per share.

CAPITAL STRUCTURE

A company will normally be registered with authorised capital in excess of the capital it expects it will require in the first instance. This is so that it will have readily available the means to issue further capital when required.

The capital required in the first instance is that necessary to cover the fixed assets, to meet the preliminary expenses, and to provide the initial working capital. Fixed assets by their nature require to be financed perpetually and will therefore be supported by the issue of capital. A part of working capital will also be permanent as it would be ambitious to think that the whole of the initial working capital *plus* the additional amount required in the company's natural growth could be financed at a future date out of profits earned and retained. Working capital will be financed therefore partly by issued capital and partly by borrowings in the form of debentures or bank overdraft facilities. Preliminary expenses are financed out of issued capital.

The capital structure depends to a great extent on the estimation of the future profits of the company and what capital they will sustain. Thus if the yield of such a concern was normally 10 per cent, and the estimated profit was £50,000, the capital that could be sustained by this profit is a maximum of £500,000 and ordinary shares to the value of £500,000 could be issued. However, it would be unwise to strain profit to its maximum and a solution would be to issue preference shares at a lower rate of dividend. If 200,000 £1 preference shares at 6 per cent and 300,000 £1 ordinary shares were issued, the burden on profit would be:

	£	
Preference Shares	12,000	
Ordinary Shares	30,000	£42,000
	<hr/>	<hr/>

This would leave a margin of £8,000.

It is quite possible that the directors require more than £500,000 as

initial capital. Assume they need £650,000; this could be achieved by issuing:

£		Interest	£
150,000	Debentures at $4\frac{1}{2}$ per cent		6,750
250,000	Preference Shares at 6 per cent	„	15,000
250,000	Ordinary Shares	Dividend	25,000
<hr/>		<hr/>	
£650,000			£46,750
<hr/>		<hr/>	

There is still a margin of £3,250 to the anticipated profit level of £50,000.

Thus various arrangements of shares can be made to achieve the object. This will depend upon the market's acceptance of the different classes of securities.

The composition of issued capital between fixed-interest securities and equities is of paramount importance to investors of both classes of security. It is therefore important to the company from the point of view of its acceptance by the investing public. This relationship is called *gearing*.

CAPITAL GEARING

A company is said to be *highly geared* when the amount of its fixed-interest-capital (including for this purpose debentures) is high in relation to its equity (usually ordinary shares). It is *low geared* when its fixed-interest-capital is low in relation to its equity capital. The *gear ratio* is the amount that the fixed-interest-capital bears to the ordinary share capital.

The following illustration will clarify this:

Capital required £120,000: Estimated profit: £12,000

	High-gearred Capital £	Scheme Dividend £	Low-gearred Capital £	Scheme Dividend £
6 per cent Preference Shares of £1	£100,000	6,000	20,000	1,200
Ordinary Shares of £1	20,000	6,000 (30%)	100,000	10,800 (10·8%)
	<hr/>	<hr/>	<hr/>	<hr/>
	£120,000	£12,000	£120,000	£12,000
	<hr/>	<hr/>	<hr/>	<hr/>

In the high-gearred scheme the gear ratio is 5:1 and in the low-gearred scheme it is 1:5. The importance lies in profit fluctuations. In the high-gearred scheme where the bulk of the capital is of fixed-interest securities, fluctuations in profit will seriously affect the

ordinary shareholder. The effect of fluctuations is far less in a low-g geared scheme. Suppose, in the schemes above, the profit fell by 50 per cent. The ordinary shareholder would receive no dividend in the high-g geared scheme. He would receive a dividend of 4.8 per cent in the low-g geared scheme. If there was a 50 per cent rise in profits, the ordinary dividend in the high-g geared scheme would be 60 per cent; in the low-g geared scheme it would rise to 16.8 per cent. From the preference shareholder's point of view the low-g geared scheme offers greater security of dividend. In times of prosperity the ordinary shareholders will tend to look for high-g geared companies but in times of deteriorating trading conditions he will switch his investment into low-g geared companies.

ADDITIONAL CAPITAL REQUIREMENTS

The methods described for the flotation of new companies apply equally to the raising of additional capital for an existing company. In floating a company, much depends upon estimates and thus adequate margins must be provided for contingencies. The calculations for additional capital can be based on known data and should be more accurate. Issues of additional capital require further considerations.

Internal Savings. Before going outside the company, the possibility of raising finance internally should be considered. Discounts need not be taken and creditors may extend their credit terms while debtors may be induced to pay their accounts sooner and late payers can be followed up. Stocks may bear investigation for pruning.

These methods in addition to bank overdraft facilities should be used where possible, especially if the shortage is temporary and caused by the need (a) to meet expenditure that will be financed by other means at a later date, or (b) to pay dividends, or (c) to meet a seasonal increase in stock or work-in-progress.

If *outside assistance* is needed the following measures may be considered subject to the rights of existing loan creditors:

- (1) Freehold land and buildings may be sold and taken back on lease rental terms.
- (2) Plant and machinery may be sold to a finance house and may be bought back under a hire purchase agreement or taken on simple hire contracts.
- (3) A loan on mortgage of the land and buildings may be negotiated.
- (4) The sales may be financed by a hire purchase firm. Alternatively, the company may enter into hire purchase sales itself and sell its rights under the hire purchase agreements to a finance house.

- (5) To avoid holding stocks of raw materials a section of production may be switched to sub-contractors.
- (6) Low profit production units may be discontinued and replaced by sub-contracting work.
- (7) In the case of products entailing a long period in production, more frequent progress payments may be used together with a reduction in the amount of retention money usually withheld.
- (8) Government aid may be available for expansion in development districts.

If needs are greater than these methods can satisfy, the Government-sponsored institution, *Finance for Industry Ltd*, may make advances when security is inadequate to enable the borrower to obtain his finance elsewhere. *Finance for Industry Ltd* was created in 1973 as a result of a merger of the *Finance Corporation for Industry* and the *Industrial and Commercial Finance Corporation*. Its activities include the providing of capital for the re-equipment and development of industry when it is not possible to obtain finance readily elsewhere. Small and medium-sized companies, particularly those involved in technical development, may be provided with capital and financial advice. The company's resources allow it to provide up to £1,000 million medium-term funds.

Equity Capital for Industry Ltd was created in 1976 as a long-term financial institution designed to provide equity, or equity-type, capital for British industry where the normal market mechanism does not make appropriate provision. Its shares are held largely by insurance companies, unit trusts and Finance for Industry; its authorised capital is £50 million.

If none of these methods is satisfactory the company must raise additional capital by issues.

RIGHTS OF EXISTING HOLDERS

An established company seeking to raise additional capital must have regard to the rights of all existing holders of shares and debentures. If it proposes to make a debenture issue, it must have regard to the rights of existing debenture-holders and their security. Such an issue will lower the cover on preference and ordinary shares and introduce a further prior charge on profits; it will raise the gearing of the company and this may not suit the ordinary shareholders.

A preference share issue must take into account the rights of existing preference shareholders. As with debentures, it will not affect the general voting rights of the ordinary shareholders but it will create a prior charge on profits and reduce the cover of the ordinary shares. It will also increase the gearing of the company which may already be highly geared.

An issue of ordinary shares will not affect the existing shareholders' rights providing it is issued to them *pro rata*. If it is not so issued or is offered to the public generally, there will be a change in the balance of voting power. It will provide a greater cover for the preference shareholders and debenture-holders. If the company is already low geared, the issue will lower the gearing still further.

SHARES ISSUED AT A PREMIUM

Shares are issued at a premium not only because of the necessity to adjust the yield but also because it may be detrimental if they are not. Assume a company with ordinary shares of £1 has:

	£
Issued Capital	100,000
Reserves	100,000
	<hr/>
	<u>£200,000</u>
Profit available for dividend	£20,000

The share value is £2 per share. The dividend is 20 per cent.

The company wishes to acquire a further £100,000 and estimates its profits will increase to £37,500. If it issues 100,000 £1 shares at par, the position will be:

	£
Issued Capital	200,000
Reserves	100,000
	<hr/>
	<u>£300,000</u>

The share value has fallen to £1.50 per share. The dividend has fallen to 18.75 per cent.

If 50,000 £1 shares were issued at £2 per share, the position would be:

	£
Issued Capital	150,000
Share Premium Account	50,000
Reserves	100,000
	<hr/>
	<u>£300,000</u>

The value of the shares would be maintained at £2 per share and the dividend would be maintained at 25 per cent.

The only limitation on shares issued at a premium is the price the market is willing to pay. Shares (but not debentures) cannot be issued at a discount except with the consent of the Court, as such issue is tantamount to a reduction in capital which is permitted only under the provisions of the *Companies Acts*.

RIGHTS ISSUES

An issue of shares usually gives the existing shareholders the prior right to take up a proportionate amount of the new issue at a price less than the current market value of the shares. This is termed a *rights issue*. A rights issue is made by issuing a provisional letter of allotment which shows the shares the member is entitled to take up and the price payable for those shares. The member may take up the issue wholly or may renounce the issue by selling his "rights" to another party, or he may take up some shares and sell his "rights" to the balance.

An issue at less than the market value of the existing shares will lower the value of the ordinary shareholder's equity but he will participate in a larger capital fund with potentially greater profit prospects. The preference shareholder will obtain more cover. Rights issues of preference shares are less common but they are made in conjunction with a similar issue to the ordinary shareholder and so preserve the *status quo*.

The price at which a member can sell his rights depends on many factors; for instance, demand for the shares, the ability to maintain the present dividend on the increased capital and the purpose for which the money is to be used.

A purely theoretical computation of the value of a rights issue is as follows:

Existing holding 4 shares: value £1.50 each	£6.00
Rights Issue 2 shares: value £1.25 each	2.50
	<hr/>
6 shares are worth	8.50
	<hr/>

One share is worth £1.41½

The Rights are worth £1.41½ less £1.25 = 16½p per share

In fact they will differ substantially from this figure and could be 25p per share (£1.50-£1.25). The reason why they could reach this figure is that they may not be procurable in quantity on the market. Furthermore, paying £1.50 per share in this way would cost the purchaser less than paying £1.50 per share on the market because no stamp duty or brokerage is payable on letters of allotment.

BONUS ISSUES

If the reserves of a company have built up so that its issued share capital is out of proportion to the capital employed, there will be a high rate of dividend. This may lead to complications discussed previously in under-capitalisation. In order to rectify the position ordinary shares are issued as fully paid up *pro rata* to existing

shareholders. It must be emphasised that the equity of the shareholders is in no way changed: their equity is merely more clearly demonstrated.

As with a rights issue, a bonus issue is made on a letter of allotment which has a saleable value. The same considerations as for a sale of rights apply to the sale of a bonus issue as far as its saleable value is concerned. A theoretical calculation of the saleable value is as follows:

Existing holding: 4 shares: value £1.50 each	£ 6.00
Bonus Issue: 2 shares	—
	<hr/>
6 shares are worth	6.00
	<hr/>

One share is therefore worth £1 and this is its saleable value.

MARKETABLE UNITS

If a company is sound, the demand for its shares will force their market value up. If the nominal value of the share is high, then few shares can be bought at one time and many small investors may not buy the shares. For these and a variety of reasons the dealings in the shares may be few. It is generally recognised that a healthy state of the company's finances exists when its shares are actively traded on the market. For this reason the nominal value of a procurable unit should be such that it offers a reasonably opportunity for the smallest investor to procure it in satisfactory numbers. Thus, over the years some shares having a nominal value of £5 per share, market value £10, have been systematically subdivided until they now stand at shares of £0.50 each; this stimulates greater activity.

VARIATION IN THE RIGHTS OF MEMBERS

So far initial issues and additional issues of capital have been considered; but there may come a time in the company's life when the whole capital structure of the company is apparently wrong. This may have arisen from badly judged capital issues, prolonged periods of trading losses or changed patterns of trade. When considering a new structure, all the considerations applying to members' rights, investors' requirements, gearing, etc., must be considered; no hard and fast rules apply. The most difficult part will be the reconciliation of the rights of preference shareholders and ordinary shareholders. The former are the most likely to suffer because the voting power is with the ordinary shareholders.

AMALGAMATIONS AND RECONSTRUCTIONS

Strictly speaking, *absorption* is where one company purchases another company, the second company being absorbed by the first company, whereas *amalgamation* refers to the sale by two or more companies of their assets to a new company formed for the purpose. As these terms are not strictly applied in practice, amalgamation will be used here to cover both operations.

Reconstructions do not necessarily involve another company. A reconstruction is simply a variation in the rights of shareholders. It can of course be facilitated by the liquidation of a company and the formation of a new company but usually, unlike an amalgamation, it affects one company or group of companies only. If only one company is concerned in a reconstruction it is called an *internal* reconstruction; if two or more companies are involved it is called an *external* reconstruction.

AMALGAMATION

This may be either horizontal or vertical (see Chapter 5). *Horizontal integration* is the joining of effort of two or more companies engaged in the same process of the same trade; for example the amalgamation of two companies in the retail grocery trade. *Vertical integration* is the joining of two or more companies in the same trade but in a different process within that trade; for example the amalgamation of a boot and shoe manufacturing company and a company owning boot and shoe retail shops.

Another type of integration seeks to smooth out the effects of trade fluctuations. This is *diversification* and its aim is to merge into one group companies engaged in different trades so that when one trade is declining another trade is approaching maximum activity; thus a textile manufacturing company may amalgamate with an engineering company.

Mention may be made here of a *consortium*. This is not an amalgamation; it is a pooling of effort where the task undertaken is too diverse and too costly for one undertaking. Immediately the task is completed and the profits are shared, the consortium comes to an end.

INTEGRATION

Whether integration takes place by the formation of a new company or by using one of the existing companies, it is necessary for the interests of the shareholders concerned to be valued as at the date of integration. Valuation is easier if the shares are quoted on the stock

exchange; otherwise the interests of the shareholders will need to be valued by reference to the current value of all the net assets and the value of goodwill which will invariably differ from the values shown in the balance sheet. It is not always necessary to include debenture-holders and preference shareholders in the transaction because it is the control of the companies that is being integrated and this concerns the equity shareholders. It may in certain circumstances be expedient to include debenture-holders and preference shareholders in the amalgamation.

Integration by means of a holding company. In this case a new company is formed to acquire the control of two or more companies. The old companies still operate under their own names; all that has happened is that the ordinary shareholders of the old companies have sold their shares to the new holding company in exchange for shares in the holding company, and the holding company has a controlling interest in each of the old companies. Usually the new company acquires all the ordinary share capital of both old companies. The holding company can itself be formed with preference and ordinary share capital and can issue preference shares and ordinary shares to the ordinary shareholders of the old companies. In this way the structure of the whole enterprise can be balanced if the previous gearing of the two companies is incorrect or if amalgamation makes the gearing unsuitable.

Integration by means of an existing company. In this case a new company is not formed as a holding company; one of the companies involved is chosen. The chosen company will issue share capital to the company or companies whose equity is being bought and thus may require an increase of its authorised capital. The chosen company should be one whose capital structure can be brought into the pattern required as easily as possible without causing such a disturbance of rights that the scheme may be thrown out by the shareholders. For the reasons discussed under amalgamation by means of a holding company, it is better to choose as the acquiring company the one whose priority claims as to capital and income are the least costly to the group as a whole. Consideration must also be given to the fact that any debenture-holders or preference shareholders of the acquiring company will be afforded greater cover than before. If both companies have equal and substantial prior interests, the formation of a new holding company should be considered.

The pre-incorporation profits position must be considered. One company may have a substantial amount of undistributed profit which, if acquired, would no longer be free for distribution.

ABSORPTION

In an absorption an existing business or company is taken over completely by another company. All the assets are acquired although sometimes debtors are left out of account and debts are collected by the absorbing company as agent for the absorbed company. If the absorbed concern is a firm, the proprietor or partners will merely take the consideration and the firm will cease, its assets and liabilities being taken by the absorbing company.

If the absorbed concern is a company, the procedure is slightly different. The absorbing company will acquire the equity of the company to be absorbed either by paying in cash or offering shares in its own company in exchange, or it will pay partly in shares and partly in cash. If the company to be absorbed has debentures and preference capital, these will be acquired either for cash or for securities in exchange, or they will be redeemed. In either case the absorbing company becomes the only shareholder of the company absorbed. It may then proceed in either of two ways: it may place the absorbed company in Members' Voluntary Liquidation in which case the liquidator will transfer the assets in consideration of the repayment of share capital or, if the absorbing company wishes to preserve the name of the old company to avoid a competitor using it or if it thinks that at some future date it may wish to commence trading in that name, it will purchase the assets for a nominal figure, say £1, and will then have a non-trading subsidiary, the only asset being £1 in cash.

The objection to absorption is the necessity to compensate the debenture and preference shareholders if they are to be repaid at a premium or if their shares stand on the market at a price less than their redeemable price. Usually a low market price indicates cheap interest rates and thus it would be more economical simply to acquire the equity. Conversely, if the market price is above the redemption value it indicates a high rate of borrowing and absorption is a cheap way of eliminating priority capital.

RECONSTRUCTIONS

An *internal reconstruction* merely changes the rights of the members and, possibly, of the debenture-holders of the company. It is a matter of evolving a scheme whereby the desired result in the capital structure is obtained. The greatest difficulty lies in balancing the rights of the various classes of shareholders interested. A reconstruction usually, but by no means always, requires some members to forfeit some right or benefit. Accordingly some inducement has to be offered either concurrently or in the future. The inducement to preference shareholders who usually suffer because they have no voting power

may be an issue of ordinary shares or the conversion of their preference shares to participating preference shares. No set rules can be laid down and any scheme depends upon the circumstances of that particular case.

In an *external reconstruction*, a new company is needed to acquire the old company's assets. The considerations in this case are the same as those in an absorption. The difference between an external reconstruction and an absorption is that in the former a new company is formed specially to effect the reconstruction whilst in the latter an existing company acquires the whole of the assets of another firm or company.

TAKE-OVER BIDS

This movement started in the banking world and culminated in today's "Big Four" (see Chapter 36). Industrial giants such as Imperial Chemical Industries Ltd, Unilever Ltd, owe their size to take-over bids and amalgamations. Many arguments have been raised for and against such practices. Whether they are good or bad depends on the reason for the take-over. If a mere quick capital profit is the aim of the bidder at the expense of the general community, the policy is bad. If the bid is for amalgamation and for the accepted results of amalgamation, it cannot always be said to be bad.

Three acceptable reasons for take-over bids are: (1) the combination of the company with other companies for the benefit of the whole; this includes the desire of a company with interests in a single field to diversify its interests and so spread its risks; for example, a leading tobacco company has acquired interests in food, confectionery and cosmetics; (2) the introduction of "new blood" into management to achieve greater profits; or (3) to change the trading of the company to a more profitable activity (a cinema may be changed into a self-service store). A fourth (and distasteful) reason is the acquisition of assets merely for quick capital gain.

To prevent a take-over bid taking place for other than reasons of amalgamation, the directors can take certain steps. They can inform the shareholders of the true worth of their assets either in the report of the directors or in the chairman's statement or they can revalue the assets in the accounts. They can recognise that profit placed to reserve is a feature of the capital employed and use the reserves to make a bonus issue. They can pay the rate of dividend demanded by the level of profit earned.

The initial stages of a bid usually take the form of purchasing shares on the Stock Exchange or, where many of the shares are held

by a small number of persons, *e.g.*, the directors, by a direct approach. Where many of the shares are widely held a circular offer to purchase their shares, sent to such shareholders, becomes necessary. As a consequence of requirements in the *Prevention of Fraud (Investments) Act 1958*, the circular offer is always made, on behalf of the bidding company, by its financial advisers, usually a merchant bank, issuing house or similar institution. These institutions, as a result of severe public criticism of the conduct of certain bids, have agreed upon a set of rules known as the *City's Code on Take-overs and Mergers*; this requires the offer to contain a great deal of information as to the assets, profits, etc., of both companies and of the market values of the shares to be acquired (and of any shares to be issued in exchange) and to be sent to the directors of the company to be acquired before it is despatched to their shareholders, so that the directors are given an opportunity to provide their members with any advice or further information they may wish to give them.

The offer is always expressed to be conditional upon holders of a specified proportion of the shares (usually 90 per cent) accepting within a stated period (usually three weeks), and to become unconditional (*i.e.*, binding on the acceptors) upon such proportion being reached. Where the bid is successful to this extent, the bidding company may compulsorily acquire the remaining shares.

CONSIDERATION

When the acquisition of shares is involved, it has to be decided whether the acquisition should be for cash or by an issue of other securities in exchange for those acquired.

If the position of the acquiring company is sound there should be no difficulty in offering shares in that company as consideration. If the position is not sound, the shareholders of the company to be acquired will prefer cash and this will lead to a wave of selling of either shares of the company to be acquired or shares of the acquiring company after they have been received; in either event, the outcome is unfavourable. When such a position is foreseen, cash should be offered rather than a mixture of cash and shares.

In order to effect the amalgamation, the acquiring company may have had to pay an enhanced price for the acquired company's shares. The acquired company's profit or future anticipated earnings may not yield as high a return, therefore, as the return being earned by the acquiring company if the whole of the purchase price was satisfied by the issue of shares of the acquiring company. To make the profit yield of each company the same, a suitable proportion of the purchase price can be satisfied by cash.

ACCOUNTING RATIOS

Many accounting ratios can be devised. Each may be of considerable importance for the purpose involved but it is of little use to calculate numerous ratios if they are going to be irrelevant. Most ratios are expressed as a percentage. It is pointless to compare one percentage with another if the basis of calculation is not the same; the basis should be consistent. If it has to be changed, the percentages worked out on the old basis should be reworked on the new basis for the purpose of comparison. Because of the need to use a common basis great care must be exercised in using ratios to compare the position in two different undertakings. To demonstrate the main accounting ratios the following abridged accounts will be used.

BALANCE SHEET

	£	£		£.	£
Issued Share Capital		200,000	Goodwill		100,000
Capital Reserve		50,000	Fixed Assets		
Revenue Reserves:			less depreciation		269,500
General Reserve	75,000		Current Assets:		
Profit & Loss Account	40,000	115,000	Investments	8,000	
			Stock in trade	60,000	
			Debtors	16,000	
			Cash at Bankers	11,000	95,000
		365,000			
5 per cent Debentures		50,000			
Reserve for future taxation		4,000			
Current Liabilities		45,500			
		<u>£464,500</u>			<u>£464,500</u>

TRADING ACCOUNT

	£	£		£
Opening Stock	48,000		Sales	138,000
Purchases	108,600			
	<u>156,600</u>			
Closing Stock	60,000	96,600		
Gross Profit		41,400		
		<u>£138,000</u>		<u>£138,000</u>

EXTRACT FROM PROFIT AND LOSS ACCOUNT

	£	
Profit before taxation	38,300	(includes £300 gross income
Taxation on the profits of the year	3,800	from Investments)
	<hr/>	
Profit after providing for taxation	<u>£34,500</u>	

CONSIDERATION OF TERMS

“*Capital employed*” normally means *fixed assets plus current assets less current liabilities*; it is then usually called “net capital employed”. Sometimes it is taken to mean the total of fixed assets and current assets and is then termed “gross capital employed”. Other definitions deduct from the net capital employed long-term indebtedness and any other form of finance that arises from outside the concern; it is then termed “proprietors’ net capital employed”.

Among many other considerations are the following: (1) should the assets be brought into account at cost ignoring depreciation or at their written-down value or at replacement costs; (2) should temporary investments that may be included in current assets be brought into account because they are not concerned in profit making; (3) should cash on current account be brought into account because it is not earning profit; and (4) should intangible assets such as goodwill be brought into account?

Arguments for and against the use of gross, net or proprietors’ net capital employed and for and against the inclusion of certain assets can be developed at length. Generally speaking, it is more usual to find the figure of capital employed as *the total of fixed assets at cost less depreciation, plus current assets at valuation, excluding temporary investments, but including cash, less current liabilities and any loans repayable within twelve months*.

Profit which enters into the calculation of the return on capital employed is also an adjustable item. Different profit figures can be revealed from the same set of figures. The important point is *consistency*—consistency in the values of assets and liabilities and in the composite items of profit. Obviously, if an asset such as a temporary investment is excluded from capital employed, the interest received from the investment must be excluded from profit.

RETURN ON CAPITAL EMPLOYED

The reason for showing the return on capital employed is to demonstrate the yield obtained by management on the funds made available for their use. What is a satisfactory return depends entirely upon the nature of the business and the amount of risk involved.

Referring to the demonstration balance sheet and accounts, the following returns may be calculated:

Return on Net Capital Employed:

$$\frac{38,300 - 300}{269,500 + (95,000 - 8,000) - 45,500} \times 100 = \frac{3,800}{311} = 12.2\%$$

Return on Gross Capital Employed:

$$\frac{38,300}{269,500 + 95,000} \times 100 = \frac{38,300}{3,645} = 10.5\%$$

Return on Proprietors' Net Capital Employed:

$$\frac{38,300}{200,000 + 50,000 + 115,000} \times 100 = \frac{3,830}{365} = 10.5\%$$

CURRENT RATIO

The current ratio is the ratio existing between *current assets and current liabilities*. Current assets are those that will mature within a year and current liabilities those that will be paid within a year.

The current asset ratio is important because it measures the growth of working capital and shows the ability of the concern to withstand setbacks and to meet any long-term indebtedness. There is no defined ideal ratio; it depends on the nature of the trade and the pattern of funds. If there are short-term borrowings, the ratio should be higher to meet these borrowings than in an undertaking without such indebtedness.

The time at which the ratio is expressed is important if profit is liable to fluctuations and if trade is seasonal.

The current ratio of the demonstration balance sheet is:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{95,000}{45,000} = \frac{19}{9} \text{ expressed as } 19 : 9.$$

This ratio is not expressed as a percentage. If the current ratio does not increase proportionately to increases in turnover, the undertaking will be overtrading.

LIQUIDITY RATIO

It has been noted that although the net current asset position may be satisfactory, the liquid position may be totally unsatisfactory. The liquidity ratio indicates the state of liquidity and is expressed as:

$$\frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{8,000 + 16,000 + 11,000}{45,500} = \frac{35,000}{45,500} = 70 : 91$$

In this case the liquid position should be improved. Generally speaking, it should be in the ratio 1 : 1; this indicates that liquid resources will meet liabilities.

CURRENT ASSETS—CONSTITUENT RATIOS

A disproportionate movement of the current ratio and the liquid ratio may be explained by expressing each item of current assets as a ratio of total current assets as follows:

$$\begin{aligned}\frac{\text{Stock}}{\text{Current Assets}} &= \frac{60,000}{95,000} = 60 : 95 \\ \frac{\text{Debtors}}{\text{Current Assets}} &= \frac{16,000}{95,000} = 16 : 95 \\ \frac{\text{Investments + Cash}}{\text{Current Assets}} &= \frac{19,000}{95,000} = 19 : 95\end{aligned}$$

If the stock and debtors ratios do not move proportionately, over- or under-production or a fall or increase in sales is indicated. If the cash ratio fluctuates, current liabilities may require attention.

FINISHED STOCK TURNOVER

The speed with which stock turns over is important. If it is disproportionately low to the period required to service orders, it may indicate that there is undue stockpiling and stocking of obsolete lines. It may also mean a falling off in sales. The stock turnover is calculated as follows:

$$\frac{\text{Cost of Sales}}{\text{Average Stock}} = \frac{96,600}{(48,000 + 60,000)/2} = \frac{96,600}{54,000} = \text{less than 2 times}$$

As this represents less than two times, it indicates that items are in stock for more than six months before sale. It may mean that the period is one at the end of stockpiling for seasonal sales. It may also mean that large obsolete items are being held or many slow-moving lines are still in stock.

In the above example, turnover has been taken at cost (*i.e.*, cost of sales) and stock has been taken at cost. Variations include taking both turnover and stock at selling prices.

GROSS PROFIT RATIO

This is the ratio of *gross profit to sales*. It indicates the average addition

to cost of sales for profit (*i.e.*, the mark-up). By itself it may be misleading as where various products are sold the gross profit on each line may differ substantially.

The gross profit ratio in the demonstration accounts is:

$$\frac{41,400}{138,000} \times 100 = 30 \text{ per cent}$$

AVERAGE COLLECTION PERIOD

When making this calculation which measures *the period of credit taken by debtors*, cash sales and sales of extraordinary items should be eliminated. The calculation is:

$$\frac{\text{Debtors}}{\text{Average daily sales}} = \frac{16,000}{138,000 \div 365} = 42 \text{ days}$$

A similar calculation may be made for creditors by use of the formula:

$$\frac{\text{Creditors}}{\text{Average daily purchases}}$$

The above ratios are those most frequently used. Others also used, but less frequently, are as follows:

Capital Employed to Fixed Assets. This shows the degree of ownership of fixed assets. The shareholders should own the whole of the fixed assets and this ratio demonstrates how far they do so.

Net Worth to Indebtedness. This illustrates the ratio of the shareholders' interests to those of loan and other creditors. Net worth is the amount of issued capital plus all reserves which belong to the shareholders. The ratio of priority capital to the equity is shown by the ratio of Preference Share Capital to Ordinary Share Capital.

Sales figure in many ratios, some of which are as follows:

Sales to working capital, which shows the use being made of working capital.

Sales to fixed assets, which shows the use being made of fixed assets in their capacity of an investment.

Sales to issue share capital or sales to net worth which show the rate at which such capital is being turned over.

Subsidiary or secondary ratios express the relationship of factory cost, selling costs, distribution costs, administration costs, capital expenditure, etc., to sales.

Stock ratios include the relationship of raw material stocks to purchases and to total sales and the ratio of work-in-progress to sales.

Ratios connected with earnings include:

Net profit (after charging preference dividends) to either the nominal value of issued ordinary share capital or this nominal value plus the reserves belonging to the equity shareholders.

The dividend policy of the company can be determined by expressing the earnings retained in the business as a percentage of the total earnings.

GOODWILL AND ITS QUANTIFICATION

Goodwill is a term in common use in business but it is a term that is difficult to define. There are several judicial definitions of the term, among them the following:

"I understand the word to include whatever adds value to the business by reasons of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things."—Lord Lindley.

"The term goodwill is nothing more than a summary of the rights accruing to the purchasers from their purchase of the business and the property employed in it."—Lord Davey.

Goodwill is essentially the acquisition of a benefit that will arise in the future. It is the projection into the future of something built up in the past but the past is used only as a basis on which to assess the future benefit. To this extent the value of goodwill is uncertain because any assessment of the future is uncertain. Nevertheless, once an estimate of future probabilities has been made, the valuation of the benefit to be received can proceed on a scientific basis.

TYPES OF GOODWILL

There are three principal types of goodwill:

- (a) that attaching to a person or persons;
- (b) that attached to a building or site; and
- (c) that attached to a product.

The goodwill attached to a building or site is very rarely the subject of a valuation. It is reflected in the value of the building or in the value of the land. The difference between the value of identical premises, one situated in the middle of a city shopping area and the other situated in a rural area, or of a petrol filling station near the intersection of main trunk roads and of one situated in a village, is essentially the goodwill attached to the location of the building or site and the value is automatically determined by the price a purchaser is willing to pay to acquire the building or site.

Goodwill attached to a product can be more accurately assessed than that attached to a person but an element of doubt must exist. Some products have become household names; they are established in the minds of shoppers who automatically ask for the product when they are making purchases. But a new manufacturer may come into the market and with a clever advertising campaign and a reduction in selling price may offer serious competition; or a well-known manufacturer who has not previously produced the particular type of product will decide to produce it in direct competition. These are probabilities that must be considered, but they are capable of being reasonably estimated.

GOODWILL ATTACHED TO PERSONS

The goodwill attached to a person or persons is the most difficult to assess. In order to assess this type of goodwill it is necessary to examine not only the influence of the person as the attracting force but all other relevant matters as well. Mr Smith may have a grocery business which is making as much profit as Mr Brown's grocery business further down the road. Mr Smith is very charming to his customers; his personality attracts custom. Mr Brown is the efficient type of person; he is rather reticent, inclined to hurry his customers and he does not pass the time of day with them. But he does buy more wisely than Mr Smith and sells his goods slightly cheaper than Mr Smith.

The purchaser of goodwill is buying future profit. The attractive force in Mr Smith's business is clearly Mr Smith but in Mr Brown's business the attractive force is mainly the quality of the commodity and the lower selling price. A purchaser of Mr Smith's business would stand to lose custom more easily than a purchaser of Mr Brown's business and therefore the goodwill of Mr Smith's business cannot be valued as highly as that of Mr Brown's business.

Previous year's trading results:

	Mr Brown	Mr Smith
	£	£
Sales	100,000	80,000
Cost of Sales	75,000	55,000
	<hr/>	<hr/>
Gross Profit	25,000	25,000
Overheads, etc.	15,000	15,000
	<hr/>	<hr/>
Net Profit	<u>£10,000</u>	<u>£10,000</u>

It is estimated that if Mr Smith sold his business 5 per cent of his customers

would stop calling at the shop. There would then be a fall rateably in gross profit and this would have the following results:

	£
Gross Profit	25,000
Less: Rateable reduction	<u>5,000</u>
	20,000
Overheads, etc.	<u>15,000</u>
	5,000
Net Profit	<u><u>£5,000</u></u>

Although it is exaggerated, this example demonstrates that loss of esteemed personal service upon which goodwill has been built can seriously affect the value to be placed upon such goodwill.

SUPER PROFIT

When a person buys a business he purchases net assets at their current worth plus goodwill. If, instead of buying that business, he were to invest his money in stocks and shares with the same degree of risk of capital, he would receive interest on his outlay without effort on his part. He could also work and receive remuneration. If the anticipated profit return from the purchase of a business, not enhanced by his own effort, does not yield more than the remuneration and interest he would otherwise receive, there is, strictly speaking, no goodwill. Goodwill is therefore the excess of profit over and above an adequate reward for the proprietor's effort plus an adequate yield on the sum invested. This excess of profit is called "super profit".

Goodwill cannot be limited to this strict interpretation, however, because wherever a business is earning reasonable profit an advantage will accrue to the purchaser by reason of the fact that the business is established. Thus, the doctor buying a retiring practitioner's practice may not receive any super profits but he will receive the benefit of the connection between the practice and patients. Connections, therefore, are a valuable benefit comprised in goodwill.

There are many more exceptions to the strict interpretation that without the presence of super profit there can be no goodwill. A "household name" product may have a secure market but the profits may not extend to super profit; monopoly of a market should be attended by super profits but if not the market monopoly may still be valuable; a retiring partner is entitled to some reward for the connections, etc., that he has helped to build up and is leaving for the benefit of the remaining partners; business "A" may have a valuable overseas connection or some other attribute that would be of great

financial benefit to business "B" and which business "B" would pay dearly to acquire; a competitor may be breaking in on a company's market and may be bought out of competition for a considerable sum, though monopoly legislation would inhibit such a proposal. However, these and other matters must be carefully valued in the light of the special circumstances prevailing.

ADJUSTMENT OF PROFIT

Goodwill as we have seen is the right to future profit but future profit can be estimated only by reference to some yard-stick. The yard-stick is the current trend and this is measured by reference to the profit achieved in the most recent years. Usually three years' profits are taken. The profit shown by the accounts needs very careful scrutiny and may require much adjustment. Income may include interest from the investment of temporary idle funds, or it may include the profit on the sale of a capital item or the proceeds of an insurance claim. Many adjustments may be required on the debit side and whatever is charged for remuneration should be adjusted to a reasonable amount. Directors of private companies are apt to draw excessive remuneration in preference to dividends, for taxation purposes; a proprietor may withdraw a very small amount from his business.

The adequacy or inadequacy of the charge for depreciation must be considered in view of the state of the assets to be acquired. Some of the adjustments that may be required before the true profit for the years concerned is determined are as follows: machines may have been bought many years previously and be at the end of their useful working life; in such cases, the charge for depreciation may be so small as to be only a nominal figure and profit will need to withstand a heavy provision for renewal of the machines; the provision for bad and doubtful debts may have been too great or too small; discount terms offered to customers may have been poor compared with terms offered currently and may need to be increased if the customers are to be retained: if the discount terms have been too generous, no adjustment should be made as the purchaser would have to stand by them for a short time at least if she wished to preserve the custom; repairs and renewals may contain a charge for an exceptional item that requires spreading backwards over relevant years or repairs and renewals may have been deferred in view of the impending sale of the concern; advertising or research and development may include a charge that requires spreading forward; and a loss on the sale of a capital item may have been charged.

VALUATION OF GOODWILL

Super profit is calculated by taking an average of the profits adjusted and deducting therefrom an adequate yield on the sum to be paid for net assets. The sum to be paid for the net assets is determined by the valuation of those assets.

The yield required is more difficult to arrive at. In order to find the interest rate to be used, it is usual to take the yield on Government securities as a measure of what is required on safe capital and then to increase the rate required by assessment of the risk to capital involved. This risk is assessed by a study of the industry generally and the concern particularly.

By way of example, let us suppose that the net assets of a business are valued at £75,000 and the return required is set at 10 per cent. The profits of the past three years, adjusted for the calculation of goodwill, have been £10,000, £11,500 and £14,000.

The average profits over the past three years are:

$$£ \frac{10,000 + 11,500 + 14,000}{3} = £11,833$$

This is not truly representative in view of the upward trend and it may be more equitable to weight the profits so that a weighted average is obtained, as follows:

$$\begin{array}{rcl} £10,000 \times 1 & = & £10,000 \\ £11,500 \times 2 & = & £23,000 \\ £14,000 \times 3 & = & £42,000 \\ \hline & 6 & \underline{\underline{£75,000}} \end{array}$$

$$£ \frac{75,000}{6} = £12,500$$

Average profits	£12,500
Return required on capital:	
£75,000 at 10 per cent	<u>£7,500</u>
Super profit	<u><u>£5,000</u></u>

From this point procedures differ.

Number of Years' Purchase: Depending upon the type of business and the facts surrounding the transaction, it may be considered reasonable to pay for four years' super profit. In this case the purchaser will pay £95,000 for the business and this is arrived at as follows:

Net tangible assets	£75,000
Goodwill (4 × £5,000)	<u>£20,000</u>
Total consideration	<u><u>£95,000</u></u>

Profit of £12,500 represents a return of 13.16 per cent on £95,000.

Capitalisation Basis: By this method the super profit is capitalised at the yield required for the business and results in a value of £125,000 as follows:

Net tangible assets	£75,000
Goodwill:	
£5,000 capitalized at 10 per cent	£50,000
Total consideration	<u>£125,000</u>

The profit of £12,500 shows the required return of 10 per cent on £125,000.

An alternative method of making this calculation is as follows:

	£
Profit of £12,500 capitalised at 10 per cent	125,000
Value of net assets acquired	<u>75,000</u>
Therefore the value of goodwill is	<u>£50,000</u>

A variation of this method recognises that the super profit stands at more risk and the topmost super profit stands at most risk. The yield required should be greater to compensate for the risk and so the valuation may result in a figure of £111,000 computed as follows:

	£	£
Net tangible assets		75,000
Goodwill:		
£2,000 capitalised at $12\frac{1}{2}$ per cent	16,000	
£3,000 capitalised at 15 per cent	<u>20,000</u>	<u>36,000</u>
Total consideration		<u>£111,000</u>

Profit of £12,500 shows a return of 11.26 per cent on £111,000.

The alternative basis of calculation here is:

Capitalisation of profit	£
£7,500 at 10 per cent	75,000
£2,000 at $12\frac{1}{2}$ per cent	16,000
£3,000 at 15 per cent	<u>20,000</u>
	111,000
Value of net assets acquired	<u>75,000</u>
Value of goodwill is therefore	<u>£36,000</u>

CRITICISM OF THESE METHODS: These three methods are not scientific. They do not take into account the fact that the goodwill will gradually be eliminated by the lapse of time. As the years pass the goodwill created by the vendor will merge with the goodwill being created by the purchaser and ultimately will disappear. The number of years' purchase method does not allow for the steady decline of goodwill. The capitalisation method does not provide for these factors because goodwill is capitalised and held in perpetuity.

The two following methods are most commonly used.

Sliding-Scale Method: This method recognises the gradual diminution in the value of goodwill and is calculated as follows:

Goodwill:

Anticipated reduction £1,000 per year for 5 years	£
£1,000 bought for 5 years	5,000
£1,000 " " 4 "	4,000
£1,000 " " 3 "	3,000
£1,000 " " 2 "	2,000
£1,000 " " 1 year	1,000
	<hr/>
Net tangible assets	15,000
	75,000
	<hr/>
Total consideration	<u>£90,000</u>

Profit of £12,500 shows a return of 13.9 per cent on £90,000.

Although this method goes half-way to meeting the requirements it is not as scientific as the annuity method.

Annuity Method: This method takes into account that money spent now to receive an amount at a future date could otherwise be invested during the interval to earn interest. The amount payable now should be discounted therefore to compensate for the interval that will elapse before the benefit is received. The present value of annual receipts of £5,000 for 4 years can be obtained by reference to annuity tables. Assume that such tables show that the present value of £1 received annually for 4 years discounted at 10 per cent is 3.17. Thus the present value of £5,000 received annually for 4 years is: £5,000 × 3.17 = £15,850.

This has not taken into account, however, the fact that the goodwill received will diminish over the years or that the topmost super profit is at the greatest risk.

Suppose, therefore, that the following position is determined. Of the super profit of £5,000

- £5,000 will be received during the first year.
 £4,000 will be received for the next year.
 £3,000 should be received in the third year but there is an element of doubt and the discount for risk should, therefore, be raised to 12 per cent.
 £2,000 should be received in the fourth year but the risk is greater, so the discount should be 14 per cent.
 £1,000 should be received in the fifth year at the same risk.

By referring to compound interest tables, the above position can be evaluated as follows:

Present value of:							£
£5,000	received	1 year	hence:	rate	10%	(5,000 × 0.909)	4,545
£4,000	„	2 years	hence:	rate	10%	(4,000 × 0.826)	3,304
£3,000	„	3	„	„	12%	(3,000 × 0.712)	2,136
£2,000	„	4	„	„	14%	(2,000 × 0.592)	1,184
£1,000	„	5	„	„	14%	(1,000 × 0.519)	519
							<hr/>
							£11,688

Thus the value of the business will be:

	£
Net tangible assets	75,000
Goodwill	11,688
	<u>£86,688</u>
Total consideration	<u>£86,688</u>

The profit of £12,500 shows a return of 14.42 per cent on £86,688.

If it was considered that the above position would prevail but the additional risk element was absent so that the discount rate should be 10 per cent throughout, it would be better to refer to the annuity table giving the present value of a stream of payments of $\frac{x}{i}$, received monthly for N years. On this basis goodwill would have been valued at £12,638 as follows:

Present value of:						£
£1,000	received	for 5 years	(1,000 × 3.962)			3,962
"	"	" 4	" (" × 3.313)			3,313
"	"	" 3	" (" × 2.599)			2,599
"	"	" 2	" (" × 1.814)			1,814
"	"	" 1 year	(" × 0.950)			950
						<u>£12,638</u>

LIMITED COMPANIES

The value of the goodwill of a limited company is very rarely the subject of a separate valuation. It is usually found by deduction from a valuation of the shares of the company.

The purchaser of debentures and priority capital usually looks for security of capital and adequate profit cover for his interest. The

purchaser of ordinary shares looks more to the earnings of the company after paying the priority interests.

After taking these matters into consideration the purchaser (who is the general public) is willing to pay such a price for the shares as will give him the yield he requires on his outlay.

Thus the following prices may be quoted as buying prices of a company's debentures and share capital:

Debenture Stock	98	
6% £1 Preference Shares	£1.05	
£1 Ordinary Shares	£1.50	
If the company has on issue:		
£10,000 Debenture Stock		
40,000 £1 Preference Shares		
50,000 £1 Ordinary Shares		
these have a market value of		£
£10,000 Debenture Stock at 98		9,800
40,000 £1 Preference Shares at £1.05		42,000
50,000 £1 Ordinary Shares at £1.50		75,000
		<hr/>
giving a total market value of the concern of		126,800
If the current value of the net tangible		
assets, valued on a going concern basis is		100,000
		<hr/>
the value of goodwill must be		<u>£26,800</u>

This same principle is used to value the shares of companies which are not quoted on the stock exchange. Such companies are usually private limited companies in which there is a close family connection between management and shareholders. Because of this relationship the profit shown by the accounts must be scrutinised very carefully and adjusted, if necessary.

The procedure is then as follows: the Stock Exchange Official Year Book or some comparable reference book should be searched to find a company whose shares are quoted and which is similar in capital structure, in the value of net assets employed, in its earnings rate, and in the same trade as the company whose shares are to be valued. If such a company is found, the proportion of earnings distributed by way of dividend and the yield required by each class of shareholder can be established. Usually it is not possible to find a company similar in every manner and so a number of nearly similar companies may be listed and comparable data can then be obtained by interpolation. The aim is to determine the yield required by investors in priority capital having the same capital cover as the company under valuation and in the case of ordinary shares the proportion of earnings paid away by means of dividend.

When these yields have been established, it is necessary to load them because of the additional risk that must be attached to management within the family and to compensate for the restriction on the free transfer of the shares that is contained in such a company's Articles of Association.

The proportion of earnings distributed by the company whose shares are quoted when applied to the company under valuation will give the amount normally distributable. This in turn will give the dividend rate on the ordinary shares.

The calculated market value is then obtained by use of the formula:

$$\text{Market Value} = \frac{\text{Nominal Values} \times \text{Rate of Dividend}}{\text{Yield Required}}$$

When the market value has been determined, the net tangible assets valued on a going concern basis are deducted, so leaving a value of goodwill. The following data, for example, relate to a private company which is to be valued:

Issued Share Capital:

60,000 £1, 6 per cent Preference Shares

100,000 £1 Ordinary Shares

Loan Capital:

£40,000 5½ per cent Debenture Stock

Temporary idle funds have been invested in the purchase of £2,000 5 per cent Corporation Stock (Market Value, 95).

The net tangible assets have been valued at £200,000.

The average earnings of the company after paying debenture interest and after providing for taxation, but including the gross income from the investment, is £24,900.

By referring to a comparable company whose shares are quoted on the stock exchange it is found that the yields required are as follows:

On Debenture Stock	5 per cent
On Preference Shares	6 " "
On Ordinary Shares	8 " "

Earnings after providing for debenture interest and taxation are appropriated as to one half for preference and ordinary shares dividend (both net) whilst the other half is retained in the company by way of reserves, etc. This accords with general practice.

To compensate for risk and restriction on transfer the preference shareholders will require their yield loaded by 2 per cent and the ordinary shareholders will require a loading of 4 per cent.

Assuming a hypothetical rate for income tax of $33\frac{1}{3}$ per cent, the procedure is as follows:

Value of Debenture Stock:

$$\frac{100 \times 5\frac{1}{2}}{5} = \frac{550}{5} = 110$$

Value of each £1 Preference Share:

$$\frac{6}{8} = £0.75$$

Value of each £1 Ordinary Share:

	£
Earnings as above	24,900
Deduct: Investment Income	100
	<hr/>
	24,800
Deduct: Retained in Company ($\frac{1}{2}$)	12,400
	<hr/>
Available for dividends	12,400
Deduct: Preference Dividend (Net)	2,400
Leaving available for Ordinary Shareholders	<hr/>
	£10,000
	<hr/>

This is equivalent to a net dividend of 10 per cent which is a gross dividend of 15 per cent.

$$\frac{15}{12} = £1.25$$

Thus the value of the company is:

£40,000 Debenture Stock at 110		£
60,000 £1 Preference Shares at £0.75		44,000
100,000 £1 Ordinary Shares at £1.25		45,000
		<hr/>
		214,000
	£	
Deduct: Value of net tangible assets	210,000	
Value of temporary investment	1,900	211,900
	<hr/>	
The value attached to goodwill is therefore		£12,100
		<hr/>

In view of the fact that preference shares are usually repayable at par on liquidation or at a small premium on redemption it is generally agreed that they should not be valued above £1.25 except in unusual circumstances. In the case of redeemable preference shares, if the time for redemption is in the near future, regard can be had to this fact and to the price for redemption.

CHAPTER FOURTEEN

Legal Aspects of Business—I: Contract

The effectiveness of the millions of dealings which make up a day's commercial activities—the exchange of goods for money across a shop counter, the payment of wages in return for work performed are examples—rests firmly on the knowledge that, in the event of disputes between parties, the machinery of the law is available to enforce contractual agreements. In this chapter we examine the outline of agreements of this nature.

THE LAW OF CONTRACT

Business transactions are usually based upon agreements known as *contracts*.

A contract has been defined as *a legally binding agreement made between two or more persons, by which rights are acquired by one or more to acts or forbearances on the part of the other or others*.

Agreement, then, is the essence of contract, but agreement is not in itself sufficient, for some agreements are not binding at law. Apart from this, certain formalities and principles must be satisfied in all cases before an agreement can be legally enforced. During the common round of business, agreements are frequently made which, through some legal deficiency, are unenforceable as contracts.

An agreement exists when two minds come together with a common intention. The intention must be common to both—there must be *consensus ad idem*, i.e., where the minds of the contracting parties have been *directed towards the same thing or set of facts*. To be a contract, the agreement must give rise to *rights and liabilities* which the law recognises and there must be a distinct intention in the minds of the parties to affect the legal relation between the parties by the creation of these rights and obligations. In other words, both parties to a contract must have a clear understanding of the rights and obligations which they wish to create. It will be clear from the foregoing that, while all contracts are agreements, every agreement is not necessarily a contract.

FORMS OF CONTRACT

It is possible to classify contracts under several heads but for present purposes only the widest and most important classification need be

indicated. A contract may be *either* implied *or* express. The former term means that the actual terms of the contract are not expressly stated either by word of mouth (orally) or in writing but are left to be understood from the conduct and dealings between parties, *e.g.*, a passenger who boards a bus makes an implied contract with the person or undertaking which runs the bus to pay the proper fare for the journey.

An express contract may be oral *or* written *or* under seal and these divisions are of extreme importance, for certain contracts must be written and some must be in writing by deed.

SIMPLE OR INFORMAL CONTRACTS include those which are made orally or in writing. In this sense writing does not mean "writing under seal", but merely the setting down in writing of the terms of a contract for the greater satisfaction of the parties concerned, and in some cases for the purpose of rendering the contract legally enforceable, for certain agreements must be in writing if they are to be enforced as contracts. Other contracts cannot be enforced at law unless there is some form of *evidence* in writing (see page 190).

SPECIALTY CONTRACTS (contracts in writing under seal) are those embodied in an instrument in writing which is signed, sealed and delivered (*i.e.*, a deed or sealed covenant).

ESSENTIALS OF A VALID CONTRACT

In whatever way a contract is created, however, it will not be legally binding on the parties thereto or enforceable by the courts unless certain legal requisites are present. The chief of these are: (a) Offer and Acceptance; (b) Consideration; (c) Legality of Form; (d) Capacity of the Parties; (e) Possibility and Legality; (f) Absence of Fraud or Mutual Mistake.

OFFER AND ACCEPTANCE

Offer and acceptance together make up the agreement which lies at the root of every contract, for a contract comes into existence only when a definite offer has been unconditionally accepted, *i.e.*, when there is a *consensus ad idem* between the parties as to the common intention contemplated in the agreement. And it matters not if a formal contract has to be drawn up later, unless the drawing up of that formal contract is actually a condition of acceptance; otherwise the contract is made up immediately the offer is otherwise accepted.

THE FOLLOWING RULES GOVERNING OFFER AND ACCEPTANCE are of importance:

- (a) The offer may be made either *generally* or to a *definite person*; but acceptance must be made by a *specific person* or persons. Thus an advertisement may constitute an offer to the public, and acceptance may be made by any individual complying with the terms of the offer, but no contract is made until the offer has been accepted by compliance with its terms by some definite person *who has knowledge of the offer and who intends to accept it*.
- (b) The offeror may *attach any conditions* he pleases, but they must be brought to the notice of the offeree *at the time when* the offer is made.
- (c) The offeror cannot bind the other party by any attempt to dispense with actual *communication* of acceptance; in other words, no contract exists until the offeree has signified his acceptance of the offer; but the acceptance may take the form of a direct communication or it may be indicated by the performance of some act which acceptance entails and which is tantamount to express acceptance.
- (d) The *offer may be revoked* at any time before acceptance (unless there is a collateral contract to the effect that the right to accept shall remain open for a certain time). The lapse of the specified time (or of a reasonable time if none is specified) or the death of the offeror or offeree before acceptance revokes the offer.
- (e) *Revocation, to be effective, must be communicated* to the offeree and must actually reach him before he has accepted; otherwise, his acceptance creates a binding contract.
- (f) *Acceptance must be unconditional*. An offer must be accepted in all its terms and any variation or modification made by what purports to be an acceptance renders it not an acceptance but a new offer to the former offeror.
- (g) *Acceptance of a specific offer can be made*, subject to the law of agency, *only by the party to whom the offer was made* and can be effected only by communication with the offeror or by doing some overt act in conformity with the offer.
- (h) Acceptance must be made *within the time stipulated* or *within a reasonable time*, and before notice of revocation. Once acceptance is given it is complete and irrevocable and a binding contract exists, provided that the other contractual essentials are satisfied.

CONTRACTS MADE BY POST

The use of the post in making contracts is subject to the following rules:

- (1) The offer is complete only when it actually *reaches the offeree*.
- (2) Acceptance is complete as soon as the *communication of acceptance is posted*. Thus, even if the letter is lost in the post, on proof of posting the acceptance is complete and binding. The same is probably true even if the offeree otherwise attempts to recall his acceptance.
- (3) Revocation of the offer is ineffective unless it reaches the offeree before he has accepted. Consequently, a revocation which is lost in the post or for any other reason fails to reach the offeree before he accepts is inoperative.

The rules are based on convenience and the observation of business practice. They do not depend on the question of whether or not the post is the agent of either party (which it is not) but it is a matter of whether or not the post was the prescribed or requested method of communication.

CONSIDERATION

CONSIDERATION is another essential feature of all simple contracts although with one or two rare exceptions, it is not necessary in the case of contracts under seal. Consideration has been defined as "*some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility, given, suffered or undertaken by the other*".

Consideration must be *real*, and to fulfil this quality it must: (a) be something that is not already legally enforceable by the other party; (b) move from the person to whom the promise is made; (c) be definite and not vague; (d) be legal; and (e) have some ascertainable legal value, however small. Consideration is not restricted to money.

Consideration must not be *past*; thus, the motive of gratitude or the feeling of moral—as apart from financial—obligation for a benefit received *in the past* is not sufficient to support a simple contract but if the past consideration is in a bill of exchange or is the written promise to pay a statute-barred debt, it will not invalidate the transaction and is enforceable.

The commercial or financial value of the consideration is not a test of the validity of the consideration as it is the parties thereto who decide the consideration and what the worth of the promise is to each. In the case of a cash sale in a shop, consideration passes at once between buyer and seller in the form of money on the one hand and goods on the other; in the case of a shopkeeper buying from a wholesaler on credit, consideration passes in the form of goods on the one hand and the promise to pay for them on the other.

EXECUTED CONSIDERATION is that which is wholly performed by one party after the contract is entered into, e.g., when goods are pur-

chased in a shop on credit the shopkeeper has done all that is due from him in handing over the goods. The consideration passing from him is said to be executed.

EXECUTORY CONSIDERATION is that obligation which remains to be performed. In the example given above the consideration given by the customer (*i.e.*, his promise) is executory, since he promises to pay at some future date.

LEGALITY OF FORM

Certain contracts, in order to be valid, must be made in a specified form; *e.g.*, under seal or in writing while others, to be enforceable, must be *evidenced* by writing.

CONTRACTS WHICH MUST BE MADE BY DEED. The following contracts are of no legal effect unless made under seal:

- (1) Contracts for the transfer of shares in British ships.
- (2) Conditional bills of sale.
- (3) Conveyances of land, legal mortgages, and leases for more than three years.
- (4) A promise without any consideration.

CONTRACTS THAT MUST BE MADE IN WRITING. Other contracts must actually be *expressed* in writing, and these include:

- (a) Bills of exchange (and promissory notes).
- (b) Assignments of copyright.
- (c) Charter parties.
- (d) Insurance and assurance contracts.
- (e) Transfers of shares in a company incorporated under the 1948 *Companies Act*.

CONTRACTS THAT MUST BE EVIDENCED BY WRITING. The following classes of contracts are unenforceable by an action in damages at law unless they are *evidenced* by some note or memorandum in writing, *i.e.*, these contracts may be perfectly valid, but no *action* can be brought on them unless and until the necessary evidence comes into existence:

- (a) A contract of guarantee or suretyship. (*Statute of Frauds* 1677, s. 4.)
- (b) A contract relating to the sale of land. (*Law of Property Act* 1925, s. 40.)

The note or memorandum which is required to make these contracts enforceable need not be made at the time when the contract is entered into, but it must exist before any action can be brought.

There is not special requirement as to form; the note is expected to be "just such a memorandum as merchants in the hurry of business might be supposed to make". The particulars must, however, include: (a) the names of the parties; (b) the subject-matter of the contract; (c) the consideration (except in the case of a guarantee); (d) the signature of the party to be charged, or of his agent in that behalf.

The absence of the written memorandum makes the contract unenforceable but not void. If the contract is breached, whilst no Common Law action for damages can be taken, if the nature of the contract permits it the equitable remedy of *specific performance* can be obtained if the applicant who has suffered the breach is able to show acts of part performance unequivocally referable to the contract.

CAPACITY OF PARTIES TO CONTRACT

A contract will be of no avail unless the parties have legal capacity or power to bind themselves by contract, and what is known as "incapacity to contract" may arise from a variety of reasons:

- (1) *Political or Professional Status*. Representatives (such as ambassadors) of foreign states in this country can sue but cannot be sued on contracts unless they agree to submit to the jurisdiction of our courts. Barristers are debarred by the rules of their profession from suing for their fees.
- (2) *Infancy*. By the *Family Law Reform Act 1969*, the majority age in respect of the contractual capacity of infants (known also as "minors") was reduced to 18 years. Persons under the age of 18 are protected by the law from the burden of certain contracts.
- (3) *Artificial Creations of the Law, such as Corporations*, acquire only limited powers subject to such limitations and such terms as the law and the constitution of the corporate body may impose, e.g., the powers of a limited company are closely defined by its Memorandum of Association.
- (4) *Permanent or Temporary Impairment of Faculties*, e.g., mental incapacity and drunkenness.
- (5) *Enemy Alien Status* in a time of war.

VOID AND VOIDABLE CONTRACTS

It is necessary to understand the difference between contracts which are *void* and those which are *voidable*. If the contract is *void* it is not binding and is of no legal effect *ab initio*, i.e., the contract is void from the very beginning and has not merely become subsequently invalid. If a contract is *voidable* it may, at the option of the party by whom it is

voidable, be either enforced or terminated at any time after its creation but during its currency without prejudice to prior rights and obligations of the parties.

LEGALITY AND POSSIBILITY

No contract can be valid unless it is both *legal* (*i.e.*, within the law and capable of being enforced at law) and *possible* of performance (*i.e.*, capable of being carried out).

ILLEGAL CONTRACTS

An illegal contract, whether the illegality is in respect of the promise, the consideration, or the subject-matter, is absolutely void even though made under seal. The court will do its best in cases where the illegality affects only part of the contract, such as undue restraint of trade or an attempt to oust the jurisdiction of the court, to sever the good from the bad terms of the contract and uphold the former, provided the promises are distinct and separate and the contract retains its general tenor and effect.

The following are the chief types of contracts which are illegal and therefore void:

- (1) Contracts to commit a crime or civil wrong.
- (2) Contracts in defiance of justice (*e.g.*, bribery of a witness).
- (3) Contracts of an immoral nature.
- (4) Contracts involving corrupt practice (*e.g.*, sale of a public office).
- (5) Contracts in undue restraint of trade, *e.g.*, imposing an unreasonable restraint on a person to carry on his trade.
- (6) Contracts made illegal by statute, *e.g.*, contracts by way of gaming or wagering.
- (7) Contracts attempting to oust the jurisdiction of the court.

IMPOSSIBILITY

Contracts, the performance of which is impossible at the time they are made, are void because of the failure of consideration. In such cases a valid contract has never existed. Impossibility may be of the three kinds:

- (1) **LEGAL IMPOSSIBILITY**, where the creation or performance of the act is prohibited by the law.
- (2) **ABSOLUTE IMPOSSIBILITY**, where physical laws absolutely prevent performance, *e.g.*, a contract to turn lead into gold.

- (3) ACTUAL IMPOSSIBILITY, where the subject-matter of the contract has, unknown to the parties, ceased to exist before the time of entering into the contract.

In these cases the impossibility existed at the time of the creation of the agreement and thus on the basis of a failure of consideration no contract ever came into existence and the agreement was devoid of legal effect. In such cases, except where the agreement was of such a nature that it was really prohibited by law as creating an illegality, any money or other consideration which may have passed under the bargain can be recovered.

RIGHTS OF THE PARTIES TO A CONTRACT

Briefly, a person who enters into a contract obtains the right to enforce performance of the contract in *all* its items; and each party to a contract becomes liable to fulfil his share of the transaction or pay compensatory damages.

Generally, the only persons who can enjoy the rights and be subject to the obligations arising from a contract are the actual parties thereto; for privity of contract exists only between the contracting persons and they alone can enforce the contract or take action upon its breach. Thus, if Jones contracts to pay £75 to Brown in consideration of Brown's promise to deliver goods to Smith, Smith cannot enforce Brown's promise for he is not a party to the original contract between Jones and Brown.

However, in most types of contract the rights under the contract may be transferred to another party who in effect becomes a party to the original contract when the right is transferred to him. The different types of contracts require different methods of transferring the rights but the rights and obligations arising under a contract of personal service cannot be assigned by the original parties. Thus debts and legal choses in action can be assigned under the *Law of Property Act* 1925; insurance and assurance contracts can be assigned under special statutes; cheques and negotiable instruments may be negotiated under the *Bills of Exchange Act* 1882; shares may be transferred under the *Companies Act* 1948; and bearer documents can be transferred by physical delivery of the document, and so on.

DISCHARGE OF A CONTRACT

The respective rights and liabilities of the parties to a contract are not satisfied until the contract is discharged. When this happens the contractual relationship is terminated, and the rights and liabilities of the parties are extinguished. A contract may be discharged by:

- | | |
|-------------------|------------------------------|
| (1) Performance | (5) Bankruptcy |
| (2) Breach | (6) Death |
| (3) Agreement | (7) Merger or Estoppel |
| (4) Lapse of Time | (8) Subsequent Impossibility |

PERFORMANCE OF A CONTRACT

Performance means fulfilment of the contract in all its terms within the time and in the manner prescribed.

Very commonly contracts are performed by the payment of money. But an agreement to pay a sum of money is not performed by *a mere willingness to pay*: the money must actually be tendered and the tender must be made under the following conditions:

- (1) The money must *actually be produced*, unless its production is dispensed with or prevented.
- (2) The tender must be in *full payment and unconditional*.
- (3) It must be made either *to the creditor himself* or to his agent.
- (4) It must be made in *legal tender currency*.

A debt is not discharged if the debtor makes a valid tender of his debt at the correct place and time and the creditor refuses such a tender; but if the creditor subsequently brings an action the debtor will have a good defence, and if he pays the amount of the debt into court before the hearing he will be awarded most of his costs in the action.

Payment of a lesser amount in discharge of a greater will not discharge a debt, as no consideration is given for the promise to forgo the balance. But there are certain exceptions to this rule in those cases where:

- (1) Payment is made before it is legally due, or by a third party with the consent of the creditor.
- (2) Payment of a liquidated (*i.e.*, definite) smaller sum is made in discharge of a greater unliquidated amount (*i.e.*, an uncertain sum).
- (3) Composition is made by a creditor under the *Bankruptcy Acts* (see Chapter 17).

If the payment of a smaller amount is to operate as a discharge, the thing done or given must differ in some way from that which the recipient is entitled to demand. Tender of something other than money (*e.g.*, a cheque) will operate as full discharge if it is accepted as such.

CONDITIONAL PAYMENT

A creditor need not accept in payment of his debt a negotiable instrument such as a cheque or a bill of exchange. If he does accept a cheque or bill he usually does so *conditionally* on the due payment of the instrument, and his right of action on the debt is suspended only until the instrument is paid or dishonoured. In the latter event his rights are revived, and he can sue his debtor, either on the debt or on the bill.

If a negotiable instrument is remitted by post and is lost, the loss will fall usually on the debtor, but, if in using the post, he acts on the instruction, expressed or implied, of the creditor, the loss will fall on the latter and the debt will be discharged.

If by agreement between the parties a negotiable instrument, *e.g.*, a bill or cheque, is taken in *final discharge* of a debt, then the creditor loses his original remedy against the debtor, *i.e.*, he loses his remedy on the debt but not on the bill if the bill is dishonoured.

BREACH OF CONTRACT

Breach of contract occurs where one party fails to perform his duties in accordance with the contract. If this is a breach of condition as opposed to one of warranty, it operates as a discharge, whereupon the rights under the contract are converted into a right of action. Breach may be by express repudiation or by conduct implying repudiation; it may take place before performance is due, or during performance; it may be either a total or a partial breach, and the remedies of the injured party depend on the nature and circumstances of the breach.

In the case of *total breach* the party injured may:

- (a) treat the breach as a discharge, refuse to perform his contractual obligations and resist any action by the other party;
and
- (b) claim damages; *or*
- (c) if he has performed a part of that which is due from him, claim an amount equivalent to the work he has done (*i.e.*, sue on a *quantum meruit*—a partly contractual and partly quasi-contractual remedy when the plaintiff seeks, not an exact sum alleged to be due to him, but a reasonable remuneration for services rendered); *or*
- (d) (in certain cases) claim specific performance or an injunction restraining the defendant from committing further acts of breach.

Should the breach be *partial* only, *i.e.*, should it apply only to a

subordinate part of a contract which is divisible, then the contract is not terminated and the injured party can sue only for damages. He must not therefore refuse to perform his side of the contract, but must proceed with the performance. He can, however, sue for the damage caused by the partial breach. Nevertheless, if the breach is of such a nature that the defaulting party clearly intends to avoid the whole of his obligations, then the whole contract can be treated as discharged, as in the case of total breach.

DISCHARGE BY AGREEMENT

A contract may be discharged by agreement in any of five ways:

- (1) **BY ACCORD AND SATISFACTION.** If one party performs his part, but in return for fresh consideration waives his rights under the contract, there is to be "accord and satisfaction".
- (2) **BY SUBSTITUTION OF A NEW AGREEMENT FOR THE OLD,** by alteration of the parties (*i.e.*, novation) or of the terms of the original contract.
- (3) **BY WAIVER,** by the parties mutually waiving their rights before either of them has performed his duties. Waiver by one party is considered sufficient consideration for waiver by the other.
- (4) **RELEASE** is similar to waiver, but is one-sided, in that one party waives his rights without any consideration; the release must therefore be under seal to be of any effect.
- (5) **CONDITION SUBSEQUENT.** This occurs when one of the terms of the contract is that the contract shall terminate if certain events do or do not occur, as the case may be, and that term comes into operation.

A contract required to be in writing may be discharged orally, but any *variation* must be written. Thus a fresh oral agreement will be sufficient to discharge such a contract without itself being effective.

DISCHARGE BY LAPSE OF TIME

Generally, the only case in which a contract is *discharged* by lapse of time is when there is a term in the contract by which the contract is to be deemed terminated by a lapse of a certain period; but in such circumstances the lapse of the period is in effect a *condition subsequent* (see above).

More frequently, however, the right of action on a contract which for some reason has terminated or been breached becomes terminated by lapse of time. It is said to become "statute-barred" by the provisions of a number of Statutes of Limitation which have been consolidated by the *Limitation Acts 1939-75*.

All rights of action are barred on a simple contract unless an action is commenced within six years of the time when the right to it accrued. The period is extended to twelve years in the case of contracts under seal or contracts of record (*i.e.*, judgments). These are the two main periods of time relevant to the limitation of contractual actions, but in addition the *Carriage of Goods by Sea Act* 1924, bars claims one year after the goods have or should have been delivered, while the *Law Reform (Limitation of Actions, etc.) Act* 1954, decrees that an action for personal injuries arising from a breach of contractual duty must generally be brought within three years, but the court is empowered to override the time limit. In the case of actions brought to recover land, the period is twelve years after the cause of action occurred and thirty years in the case of the Crown.

Although the periods in each case begin to run from the date when the plaintiff could first have sued, yet part performance, part payment or payment of interest by the person liable will revive the remedy, and the various periods will again begin to run from the date of revival. Similarly, the right of action will be revived by acknowledgment of the debt in writing from which may reasonably be inferred an intention to pay and if at the time the right of action arises the defendant is under the disability of infancy or insanity or if the plaintiff is unaware of his right of action through the fraud of the defendant, the period of limitation does not commence until the disability is removed.

BANKRUPTCY AS A DISCHARGE

If a party to a contract is adjudicated bankrupt (see Chapter 17), the whole of his assets, rights and liabilities are vested in his trustee, who becomes the only person entitled to carry out the bankrupt's obligations and to enforce his rights, so that the only person who can be proceeded against in respect of the contract is the trustee with whom all claims must be lodged and who must, as far as the assets permit, discharge claims in a statutory order of preference.

DISCHARGE OF A CONTRACT BY DEATH

A contract (other than one which involves personal service) is not discharged by the death of either party. On the contrary, the rights of the deceased pass to his personal representatives; so that if the deceased had already performed his side of the agreement the representatives will be able to enforce performance by the other party.

MERGER AND ESTOPPEL

"Merger" implies the substitution of a higher grade of contract for a lower one. Thus a contract under seal will supersede a simple contract, whilst a judgment by a court (called a *contract of record*) will supersede the deed. At the same time, if judgment is given against, say, the defendant to an action brought on a contract, the judgment will *estop* the defendant from proceeding further on the contract.

SUBSEQUENT IMPOSSIBILITY OR FRUSTRATION

It has already been pointed out that if an agreement is impossible of performance in law or in fact at the time it is entered into, it is of no contractual effect. But where performance becomes impossible *after* the contract has been made, the general rule is that the contract is not discharged. There are, however, certain exceptions to this rule, and it may be said that *subsequent* impossibility discharges or frustrates a contract when (a) a change of law makes performance illegal; (b) the death of one of the parties makes performance impossible; (c) performance depends on the existence of a certain person or thing, who or which ceases to exist; and (d) the happening of an event is of the essence of the contract and the event fails to happen.

The *Law Reform (Frustrated Contracts) Act 1943*, provides, in general, that if a contract becomes frustrated, money already paid is recoverable and money due ceases to be payable, allowance being made for expenses properly incurred by the recipient under the contract up to the date of the frustration.

DAMAGES ON BREACH

The damages to be recovered by the plaintiff may be classified as (a) *liquidated*, in which case statute law, e.g., the *Sale of Goods Acts 1893*, or the *Bills of Exchange Act 1882*, or other Act appropriate to the contract, states how the amount of damages recoverable may be ascertained. It may be, however, that the parties to the contract agreed the amount recoverable on breach in the terms of the contract and if this amount (which is also termed "liquidated damages") has been ascertained on the inception of the contract by an honest pre-estimation of possible loss, then that amount will be awarded by the Court, irrespective of the loss actually suffered. If however the amount stated in the contract was not an honest pre-estimation but put in merely to punish the defendant and not to compensate the plaintiff, by its nature it is a penalty and will therefore not be enforced. In such a case the court will proceed to assess damages on the unliquidated basis. (b) Where no provision for damages has been made in the

terms of the contract it will devolve upon the court to assess the amount of damages suffered. The court will endeavour, so far as is possible, to place the plaintiff in the same pecuniary position as if the contract had performed, but will award him damages only for such loss as was incurred directly and naturally as a result of the breach. But if the breach has resulted in some special loss which, although not contemplated by the parties when the contract was made, is yet a natural result of the breach, *and* it is shown that the defendant was aware of the *special* circumstances out of which the loss arose and further that the defendant had impliedly or expressly agreed to liability for special loss, then the plaintiff will be awarded special damages to cover this extra loss.

In some cases, where the loss could not be covered by the award of damages, the court may grant what is known as an order for *specific performance*, *i.e.*, the defendant will be ordered to carry out his agreed duties under the contract, but such an order will be made strictly at the discretion of the court. Yet another remedy open to an injured party under a contract is to apply to the Court for an *injunction* either restraining the other party from doing certain actions *or* compelling him to perform some specified action, as the case may require.

CHAPTER FIFTEEN

*Legal Aspects of Business—II: Employment
Legislation and Collective Bargaining*

Given the large proportion of the population in the U.K. engaged in work, a satisfactory system of employer-employee relationships has become a vital matter for the functioning of the economy. A novel feature of recent years has been the intervention of the state in those relationships—an area traditionally associated with the principles of *laissez-faire*. Until the mid-1960s there was little legislation which impinged directly on the employer-worker legal relationship. From that time, however, the situation has changed dramatically so that, although in theory the contractual relationship between employer and employee might be said to arise from free bargaining between them as to terms and conditions of employment, in practice the situation is quite different. Acts of Parliament, statutory instruments and other regulations now cover the entire field of employment, ranging from “hiring to firing”.

In this chapter some of the principal statutes affecting employment are outlined together with a sketch of the essential features of collective bargaining.

ASPECTS OF THE MODERN LAW OF EMPLOYMENT

Employment legislation takes into account engaging an employee, terms and conditions of work, the rights accruing to members of trade unions and the circumstances of dismissal. Rights create duties, so that the many *rights* bestowed on employees as the result of recent legislation mean, in practice, an increase in the range of *duties* expected from employers. Ignorance of the law may not be pleaded as a defence; employers and those who represent them, *e.g.*, personnel officers, staff managers, are expected to know and apply current legislation to their dealings with employees.

ENGAGING THE EMPLOYEE

In 1898, Lord Davey in a House of Lords judgment, stated: “An employer may refuse to employ an employee for the most mistaken, capricious, malicious or morally reprehensible motives that can be conceived, but the employee has no right of action against him.” That principle remains valid, but legislation has vitiated its effect.

Thus, the *Sex Discrimination Act 1975 (S.D.A.)* now provides that it is unlawful, in relation to employment, to discriminate against a woman in the arrangements made for the purpose of determining who shall be offered that employment, or in the terms on which an employer offers her that employment, or by refusing or deliberately omitting to offer her that employment. (The principle applies equally to discrimination against men.) There are few exceptions to the rule. Further, under the *Race Relations Act 1976*, it is unlawful to discriminate, in relation to offering employment, on grounds of colour, race, nationality, ethnic or national origins. The few exceptions to this general prohibition relate to the existence of genuine occupational qualifications, for example.

THE CONTRACT OF EMPLOYMENT

A contract of employment need not be in writing (except in the case of a contract of apprenticeship and a contract under the *Merchant Shipping Act 1970*). Under the *Contracts of Employment Act 1972 (C.E.A.)* as subsequently amended, however, certain information relating to terms and conditions of employment must be given to an employee in the form of a written statement not later than thirteen weeks after the commencement of employment.

The information required in the statement is as follows:

- (a) names of employer and employee and date when employment began;
- (b) whether any employment with a previous employer counts as part of the employee's continuous period of employment for the purposes of *C.E.A.*;
- (c) details of remuneration, *e.g.*, scale or rate, intervals of payment;
- (d) terms and conditions relating to holiday entitlement, hours of work, sickness and injury, length of notice.
- (e) disciplinary rules, procedure relating to redress of grievances;
- (f) title of job.

Periods of notice required are now as follows (but it should be noted that the statutory rights to notice arise only after continuous employment for four weeks): 1 week's notice in the case of continuous employment from four weeks to less than two years; 1 week's notice for each year of continuous employment in the case of employment from two years to less than twelve years; 12 weeks' notice if the period of continuous employment is twelve years or more. The statutory period of notice from employee to employer is, after four weeks' employment, one week only. Certain categories of employees are ex-

cluded from the operation of these provisions, *e.g.*, part-time employees whose working hours are normally under 16 hours weekly, merchant seamen, Crown servants.

EQUAL PAY

The *Equal Pay Act* 1970 took effect in 1976; it was amended by the *S.D.A.* and has application to all contracts relating to employment in Britain. In every such contract there is now deemed to be an "equality clause", *i.e.*, a provision which has the effect that where a woman is employed on "like work" or on "work rated as equivalent" with that of a man in the same employment, any term of the contract of employment less favourable to the woman is to be treated as modified so that it is not less favourable. Where the woman's contract does not include a term corresponding to a term in the man's contract, her contract is to be treated as though it included such a term. The Act applies equally to men and women.

Where an employee claims equal pay by virtue of work "rated as equivalent", she must show that the work has been so rated under a job evaluation exercise or study. That study must involve full discussions between employers and employees or their representatives.

TRADE UNION RIGHTS

The rights of a trade union member are covered largely by legislation such as the *Trade Union and Labour Relations Act* 1974 (*T.U.L.R.A.*), as subsequently amended, and the *Employment Protection (Consolidation) Act* 1978 (*E.P.A.*). It should be noted that the legislation relates only to "independent" unions, *i.e.*, those unions not under the domination or control of an employer and certified to be independent by the Certification Officer.

Where recognition or non-recognition of a union leads to dispute, advice can be given by the *Advisory, Conciliation and Arbitration Service* (*A.C.A.S.*). *A.C.A.S.* may offer assistance by conciliation and, where necessary, may inquire into a recognition dispute and publish its findings. Where findings are referred to the *Central Arbitration Committee* that Committee may make an award that the employer shall observe the terms and conditions specified in the union claim; effectively, therefore, the union is "recognised", although the Committee cannot insist on formal recognition.

An employer may not take action against an employee for the purpose of deterring him from being or seeking to become a member of an independent union or compelling him to become a member of a non-independent union. Time off for union members for the purpose

of participating in union activities is allowed under E.P.A.; this does not include industrial action. Paid time off for union officials to carry out their duties is also allowed.

The rights of a trade union member in relation to dismissal arising out of his membership of the union are mentioned on page 204.

THE CLOSED SHOP

A closed shop exists where a term of employment of each individual is that he is or will become a member of an appropriate, specified trade union. The right of employers and trade unions to operate a closed shop is recognised by *T.U.L.R.A.*, as subsequently amended.

In practice, therefore, where a closed shop agreement exists, as in the coal mining industry, employment is conditional on the employee's membership of a recognised, independent union and dismissal of a worker who refuses to join such a union is not, in those circumstances and save with some few exceptions, necessarily "unfair".

OTHER RIGHTS OF THE EMPLOYEE

Recent legislation has resulted in the following rights which are now applicable to employees:

- (a) *Maternity rights.* Under *E.P.A.* a female employee is considered as having been "unfairly dismissed", and may appeal to an Industrial Tribunal, if the principal reason for her dismissal was that she was pregnant, except where it can be shown that at the date of her dismissal she was or would have been incapable of adequately doing the work she was employed to do. A female employee is entitled to "maternity pay" after a qualifying period of two years' service. She must continue to be employed until immediately before the beginning of the 11th week before the expected week of confinement. In general, she has the right to re-instatement if she offers to return to work at any time before the end of the period of 19 weeks from the confinement.
- (b) *Itemised pay statement.* Under *E.P.A.* every employee has the right to be given an itemised pay statement showing the gross amount of wages or salary, amounts of fixed or variable deductions, net amount of wages or salary and amount and method used relating to any part payments.
- (c) *Time off for public duties.* Employees have the right to time off for duties where they are, e.g., justices of the peace, members of local authorities or statutory tribunals.

- (d) *Statutory guarantee payments.* Under *E.P.A.* a worker who has at least four weeks' continuous service with an employer has a right to guaranteed payments where he is not provided with work by that employer by reason of a diminution in the requirements of the employer's business for work of the kind which he is employed to do.
- (e) *Redundancy payments.* Under the *Redundancy Payments Act 1965* as amended by *E.P.A.* an employee who has been continuously employed for the requisite period who is dismissed by reason of redundancy has the right to redundancy payment. Before becoming entitled to such payment the employee must have been dismissed. It should be observed that "redundancy" refers to a dismissal attributed wholly or mainly to the fact that the employer has ceased or intends to cease to carry on his business, or the fact that requirements of that business for employees to carry out work of a particular kind have ceased or diminished or are expected to cease or diminish.

DISMISSAL

An employee is treated as having been dismissed by his employer where the contract is terminated by the employer with or without notice, where under a fixed term contract the term expires without renewal or where the employee terminates the contract, with or without notice, in circumstances such that he is entitled to terminate it without notice by reason of the employer's conduct ("constructive dismissal"). (The question of whether or not that has been a "constructive dismissal" is determined in accordance with the law of contract.)

Conduct justifying a summary dismissal includes, *e.g.*, gross misconduct. Under *E.P.A.* an employee who has been continuously employed for a period of 26 weeks can request from his employer a written statement setting out the reasons for the dismissal.

Employees now have the *right* not to be unfairly dismissed. Once a dismissal has been established, it is for the employer to show that it was due to one of the following reasons (and that he had acted reasonably in the circumstances): capability or qualifications; conduct; redundancy; breach of statutory duty; other substantial reason. Dismissal is unfair if, *e.g.*, the principal reason was the employee's wish to become a member of an independent union, or that he had participated in the affairs of such a union or that he had been selected for redundancy because of his trade union involvement. The employee's remedies include application to an Industrial Tribunal, which may award reinstatement, re-engagement or compensation.

COLLECTIVE BARGAINING

The traditional concept of a wage as being based on an individual contract emerging from unrestricted bargaining between employer and employee has, in practice largely disappeared as the result of minimum wage legislation, wage freezes and government-fixed "wage ceilings". The principle of collective bargaining has also played an important role in hastening the demise of the "individual" wage contract.

Collective bargaining is based on the principle that individual employees are in very weak bargaining positions; they attain strength only when they combine in a union. From the employers' side, it would be impossible to negotiate thousands of individually-bargained contracts. Hence the need for representative bargaining on both sides.

"The relationship between trade unions and employers' associations arises principally in the process of negotiating and applying collective agreements, and the rules established by these agreements form a considerable part of the framework within which managers and workers deal with each other. 'Collective bargaining' is a term coined by Beatrice Webb to describe an agreement concerning pay and conditions of work settled between trade unions on the one hand and an employer or association of employers on the other. Thus it covers any negotiations in which employees do not negotiate individually, and on their own behalf, but do so collectively through representatives": *Royal Commission on Trade Unions and Employers' Associations, 1965-68*.

Collective agreements negotiated by unions and employers and resulting from collective bargaining cover the vast majority of employees, whether union members or not. It must be noted, too, that under *T.U.L.R.A.* a collective agreement is conclusively presumed *not* to have been intended as a legally enforceable contract *unless* it is in writing and contains a provision that it is intended by the parties to be legally enforceable.

Collective bargaining is held in law to cover negotiations relating to or connected with the following matters: terms and conditions of employment; engagement, termination or suspension of employment of workers; allocation of work or duties; membership or non-membership of unions; discipline; facilities for union officials; machinery for negotiation or consultation.

As collective bargaining has grown in scope and importance two central bodies, speaking for large sections of workers and employers, have emerged and grown in strength. The Trades Union Congress and the Confederation of British Industry are considered below.

THE TRADES UNION CONGRESS (T.U.C.)

The T.U.C. was founded in 1868 and has grown into the unions' recognised central, representative body. Membership comprises 115 affiliated unions, with a total number of members of around 11.5 million, representing over 90 per cent of total union membership in the U.K. (since not all unions are affiliated to the T.U.C.) and almost one-half of the total working population. Affiliated unions vary in size from the tiny Cloth Pressers' Society, with 70 members, to the giant Transport and General Workers' Union with 2,022,738 members. Unions may be organised on the basis of *craft*, e.g., woodworkers, *industry*, e.g., railways, or *general*, non-specialised activities, e.g., transport and general workers.

Congress, which meets annually, is constituted by delegates from the affiliated unions. It elects a *General Council* which has the responsibility of observing closely matters affecting the trade union movement generally and promoting common action on union affairs. Membership of the T.U.C. does not involve unions in surrendering their autonomy. The T.U.C. has the right, however, to suspend or exclude an affiliated union from membership where that union is judged to have acted in disregard of T.U.C. decisions or policy.

T.U.C. AFFILIATED MEMBERSHIP 1977

Trade Group (with numbers of unions)	Total membership
Mining and Quarrying (3)	295,876
Railways (3)	282,031
Transport (other) (6)	2,041,259
Shipbuilding (1)	128,403
Engineering and Vehicle Building (10)	398,293
Technical Engineering and Scientific (4)	610,852
Electricity (1)	420,000
Iron, Steel and other metal trades (10)	142,333
Building, Woodworking and Furniture (5)	386,374
Printing and Paper (6)	406,417
Textiles (16)	127,073
Clothing, Leather, Boot and Shoe (6)	258,400
Glass, Ceramics, Chemicals, Food Drink and Tobacco, Distribution (10)	570,028
Agriculture (1)	85,000
Public Employees (10)	2,100,680
Civil Servants and Post Office (12)	954,642
Professional, Clerical and Entertainment (10)	391,821
General Workers (1)	916,438
TOTAL (115 unions)	11,515,920

Source: T.U.C.

The T.U.C. represents the views of its members in discussions with Government Departments. It is represented on a number of important bodies, such as the National Economic Development Council and the Health and Safety Commission.

The table on page 206 shows the membership of the T.U.C. in 1977.

THE CONFEDERATION OF BRITISH INDUSTRY (C.B.I.)

The C.B.I. was formed as the result of a merger of the Federation of British Industries, the British Employers' Confederation and the National Association of British Manufacturers. It has emerged in recent years as the central body representing British industry. Its membership consists of around 10,000 companies and some 200 employers' organisations, trade and commercial associations. The percentage of the C.B.I.'s industrial company membership in relation to size of firm was, in 1977: under 50 employees, 40 per cent; 51–200 employees, 31 per cent; 201–1,000 employees, 16 per cent; over 1,000 employees, 13 per cent. Some nationalised companies have associated membership.

The principal activities of the C.B.I. include advisory and consultative tasks and representing its members on bodies such as the National Economic Development Council and the Manpower Services Commission. It puts forward the views of its members to Government Departments and acts as the spokesman of employers in making known to the public their views on industrial and economic issues.

CHAPTER SIXTEEN

Legal Aspects of Business—III: Taxation

The widening sphere of the State's activities in the twentieth-century accounts almost entirely for the huge increases in taxation. The three principal categories of central government expenditure in the U.K. are: expenditure authorised by annual *Appropriation Acts*, including expenditure on defence, general administration, social services, etc.; expenditure specifically authorised on defence, general administration, social services, etc.; expenditure specifically authorised by Acts of Parliament, other than Appropriation Acts, *e.g.*, the Consolidated Fund Standing Services; Government lending administered by the National Loans Fund, *e.g.*, domestic lending to the nationalised industries. A chart showing Public Expenditure for 1976–77 is set out on page 209.

BUDGET SURPLUS AND DEFICIT

A budget surplus, arising when revenue is set against expenditure from the Consolidated Fund (*i.e.*, The general account into which government receipts are paid and out of which payments are made in the form of standing charges) will be transferred into the National Loans Fund Account. A budget deficit will be financed initially by government borrowing from that Fund. The Budget may be considered as a financial statement presented annually to Parliament—although, exceptionally, supplementary Budgets may be presented later in the year—by the Chancellor of the Exchequer in which revenue and expenditure for the past year are outlined and provision made for the coming financial year. In particular, proposals for changes in taxation are embodied in a subsequent *Finance Bill*.

BASIS AND PRINCIPLES OF TAXATION

A tax has been defined as *a compulsory contribution to a public authority, intended to meet the expenses of government and the the provision of general benefits*. Theories of taxation include: the *benefit theory*, according to which taxes are considered as payment for benefits received by persons from services supplied by the government; and the *socio-political theory*, according to which taxation is a weapon in the government's armoury designed to give effect to those aspects of public policy intended to make social changes.

PUBLIC EXPENDITURE 1976-77

£ million

<i>Defence and external relations (UK)</i>	
Defence	5,621
Overseas aid and other overseas services	1,062
<i>Commerce and industry</i>	
Agriculture, fisheries and forestry	1,003
Trade, industry and employment	3,074
<i>Government lending to Nationalised industries</i>	800
<i>Environmental services</i>	
Roads and transport	2,716
Housing	4,680
Other environmental services	2,560
Law, order and protective services	1,848
<i>Social services</i>	
Education and libraries, science and arts	7,519
Health and personal social services	6,533
Social security	11,168
<i>Other services</i>	
Other public services	838
Common services	849
<i>Northern Ireland</i>	1,627
<i>Total programmes</i>	51,898
Debt interest	1,820
TOTAL	53,698

Source: The Government's Expenditure Plan,
Cmnd 6721-1.

CANONS OF TAXATION

A number of basic principles—some of which first appeared in the writings of Adam Smith (*Wealth of Nations*, pub. 1776)—have been advanced.

- Equality*. The burden of taxation ought to be distributed among taxpayers according to their ability to pay.
- Certainty*. The manner of payment, the amount to be paid, ought to be clear to the taxpayer.
- Convenience*. Taxes ought to be levied at the time and in the manner most convenient for the taxpayer.
- Economy*. As little as possible, consistent with efficiency, should

be taken from the yield of taxation to meet costs of administration and collection.

- (e) *High yield.* A tax should have a high net yield, but not so high as to damage its source of payment.
- (f) *Elasticity.* It ought to be possible to adjust the rate of a tax to meet changed financial circumstances.

IMPACT AND INCIDENCE

The *impact* of a tax is said to be on the person from whom that tax is initially collected. The *incidence* is said to be on the person on whom the tax burden ultimately rests. Thus, taxes on income generally rest at the point of initial impact; taxes on commodities may be passed on to the consumer.

DIRECT TAXATION

Direct taxes are those borne by the persons upon whom they are actually levied, *e.g.*, income tax.

- (a) The *advantages* of direct taxation include the following:
 - (i) Incidence is easy to determine
 - (ii) Direct taxation can be made “progressive”, *i.e.*, the rate may be increased as one’s income increases, thus conforming to principles of equity.
 - (iii) Costs of collection are comparatively low.
 - (iv) The taxpayer generally knows exactly how he has to pay.
 - (v) The interest of the taxpayer in the spending of public money is stimulated.
- (b) The *disadvantages* of direct taxation should be noted:
 - (i) It is not easy to devise a system that is fair for all classes.
 - (ii) Evasion is encouraged, more particularly when rates of direct tax are high.
 - (iii) Effort and enterprise may be penalised and discouraged where rates of direct taxation are highly progressive.

INDIRECT TAXATION

Indirect taxes are imposed on goods and services so that impact and incidence are on different persons.

- (a) The *advantages* of indirect taxation may be summarised thus:
 - (i) Collection is relatively easy.

- (ii) Evasion is not easy.
 - (iii) Those with small incomes can be reached.
 - (iv) Some commodity duties are elastic in yield, *i.e.*, revenue increases with an increase in duty levied.
 - (v) Commodity taxes enable foreign visitors, who would otherwise be exempt from taxation, to be reached.
 - (vi) Some forms of consumption, *e.g.*, of tobacco and alcohol, can be controlled in part.
 - (vii) The taxpayer does not feel the burden so directly.
 - (viii) The method of payment is relatively convenient.
- (b) The *disadvantages* of indirect taxation include the following:
- (i) Indirect taxation is rarely equitable; it is regressive in character, so that the proportion of the taxpayer's income paid in indirect taxation tends to diminish as that income increases.
 - (ii) Revenue is uncertain and incidence is not easy to determine.
 - (iii) The real cost of collection may be high.
 - (iv) An increase in the rate does not necessarily result in an increased yield.
 - (v) The tax may be shifted on to those who were not intended to bear it.
 - (vi) Inconvenience to trade may result.

THE BRITISH TAXATION SYSTEM

The British scheme of taxation is a *composite system*; it comprises direct and indirect taxes. The three main sources of tax revenue are: taxes on income, *e.g.*, income tax and corporation tax; taxes on capital, *e.g.*, capital gains tax; taxes on expenditure, *e.g.*, V.A.T., revenue duties.

Estimated receipts from taxation (and other sources) for the years 1976–77 are set out in the table on page 212.

EXAMPLES OF SOME PRINCIPAL TYPES OF TAX

The taxes selected for discussion in the following paragraphs are:

- (a) Income Tax;
- (b) Corporation Tax;
- (c) Capital Gains Tax;
- (d) Value Added Tax.

RECEIPTS FROM TAXATION AND OTHER SOURCES

£ million

	1976/77
Taxation	
Inland Revenue: Total	20,710·0
Income tax	17,012·8
Surtax	62·2
Profits tax	0·2
Corporation tax	2,654·9
Capital gains tax	323·4
Estate duty	124·4
Capital transfer tax	259·2
Stamp duties	271·6
Special charge	0·2
Development land tax	1·1
Customs and Excise: Total	10,900·0
Beer	807·4
Wines and spirits	1,137·8
Tobacco	1,873·9
Hydrocarbon oils	2,065·2
Protective duties	675·0
Agricultural levies	52·7
Betting	284·2
V.A.T.	3,778·4
Car tax	226·8
Other	5·5
Import deposits	—
less Export rebates	6·9
Motor vehicle duties	845·9
Total taxation	32,455·9
Miscellaneous receipts:	
Interest and dividends	189·9
Broadcast receiving licences	246·7
Other	885·4
Total revenue	33,777·9

Source: H.M. Treasury

INCOME TAX

Income tax is imposed for the year of assessment beginning on 6th April. When imposed for any year it is charged for that year "in

respect of all property, profits or gains respectively described in the Schedules”, and “in accordance with the provisions of the *Income Tax Acts* respectively applicable to those Schedules”: *Income and Corporation Taxes Act 1970, s. 1*. The basis of the system is currently a “unified tax” and allows for a charge to income tax at the basic rate on the first “slice” of a taxpayer’s income after deduction of appropriate reliefs, and a charge at successively higher rates with reference to the “slices” by which his total income is in excess of the first “slice”.

SCHEDULE A

Under this Schedule tax is charged on annual profits or gains arising from rents under leases of land in the U.K., and other similar receipts. Tax is chargeable on persons receiving or entitled to receive such profits or gains.

SCHEDULE B

Tax under this Schedule is charged on the occupation of those woodlands in the U.K., managed on a commercial basis with the aim of making a profit. The occupier is charged on the “assessable value” of his occupation in the “chargeable period”. That “assessable value” is generally one-third of the “annual value” of the woodlands; the “annual value” is a notional value based on the assumption that the land, instead of being woodland, has been let in its natural, unimproved state.

SCHEDULE C

Under this Schedule tax is charged in respect of all those profits arising from public revenue dividends payable in the U.K. in a chargeable period, also from similar dividends payable in the Republic of Ireland and entered in the Bank of Ireland register. Tax under Schedule C is charged on the appropriate person making payment, who will pay the tax on behalf of persons entitled to the profits.

SCHEDULE D

Tax is chargeable under this Schedule on the full amount of income which precedes the year of assessment. It is charged in respect of: profits or gains of any trade carried on wholly or partly within the U.K.; profits or gains of any profession or vocation not covered by any other Schedule; interest on money, annuities or other annual payments, except payments chargeable under Schedule A; income

arising from securities payable from public revenue and not chargeable under Schedule C; income arising from securities out of the U.K., where not charged under Schedule C; income arising from possessions out of the U.K., but not including income consisting of emoluments of any office or employment; other annual profits or gains not falling under Schedules A, B, C or E.

SCHEDULE E

Tax is charged under this Schedule in respect of: any office or employment on emoluments therefrom falling within the Schedule; pensions or annuities; family allowances; payments of benefit under the *Social Security Act 1975* except death grant, unemployment benefit, sickness benefit, etc.

SCHEDULE F

Tax is chargeable under this Section for any year of assessment on all dividends and other distributions in that year of companies resident in the U.K. which are not excluded specially from income tax.

EXEMPTIONS FROM INCOME TAX

The principal classes of exempted income include: accumulated interest on U.K. national or war savings certificates; interest on post-war credits; social security benefits, but not, *e.g.*, some family allowances; income from scholarships, bursaries, etc., held by a person undergoing full-time instruction at an educational establishment; interest on damages for personal injuries; certain types of income of charities.

Whole or partial exemption from income tax is allowed on the case of, *e.g.*, dividends or interest paid by a building society; sums payable under certain types of contractual savings schemes.

PERSONAL RELIEFS

An individual taxpayer's personal reliefs are deducted from total income. It should be noted that there is no rule which allows any excess of an individual's personal reliefs which remain unallowed for a given year of assessment to be carried backward or forward to any other years.

Personal reliefs include: relief to a married man whose wife is living with him for the year of assessment or who is wholly maintained voluntarily by him during that year; wife's earned income

relief; child relief in respect of a widow's or widower's housekeeper; relief for relative taking charge of an unmarried person's younger brother or sister; relief for dependent relatives; relief for daughter's services; relief for some types of premiums on life policies.

DEDUCTIONS FOR NECESSARY EXPENSES

Certain types of expenditure incurred wholly, exclusively and necessarily in employment may be deducted from emoluments for the purpose of income tax.

Allowable expenses include, for example (in the case of a trader): bank charges on business accounts; heating, lighting, power charges relating to, *e.g.*, a shop; insurance premiums relating to, *e.g.*, trading stock; leasing costs; printing and stationery costs; some repairs (but not improvements) to business premises.

Examples of non-deductible expenses are: capital expenditure; depreciation; fines and penalties; occasional loans to customers.

CAPITAL ALLOWANCES

In general, capital allowances may not be claimed in relation to capital expenditure; they may be available, however, in the case of certain classes of wasting assets, *e.g.*: industrial buildings and structures; machinery and plant; scientific research; agricultural or forestry land; mines and oil wells.

A trader may be given an "initial allowance", or, in relation to capital expenditure on plant and machinery, a "first year allowance", as soon as capital expenditure which qualifies under the statutory rules is incurred by him. He may also receive an annual "writing-down allowance" until the asset ceases to be owned by him, or ceases to be used for trade purposes.

P.A.Y.E.

The system of Pay-as-you-earn was introduced under the *Income Tax (Employments) Act 1943*. In essence, the system allows income tax in respect of emoluments under Schedule E (income from employment) to be deducted by employers from wages and salaries. Its distinctive features are as follows:

- (a) The tax is deducted by the employer, who is accountable to the Collector of Taxes.
- (b) The employer receives from the Inspector of Taxes, before the commencement of the year of assessment, a tax deduction card

relating to each employee which shows his code number, and a set of tax tables.

- (c) Tax deducted is related to the employee's emoluments for the year which he has received to date, the proportion of personal reliefs for that year to date which are deducted from income, and the amount of income tax previously deducted from emoluments in that year.

ADMINISTRATION OF INCOME TAX

The administrative structure relating to the assessment and collection of taxes is based on the following persons and bodies:

- (a) *Board of Inland Revenue.* The Board is responsible for the care and management of direct taxes. It comprises the Commissioners of Inland Revenue, who are full-time civil servants.
- (b) *Inspectors of Taxes.* The Inspectors are full-time civil servants appointed by the Board of Inland Revenue; they act under the Board's general direction. Their functions include the issuing of notices requiring returns of income, and Tax assessment.
- (c) *General and Special Commissioners.* The function of the Commissioners is the hearing and determination of appeals relating to tax matters. *General Commissioners* are part-time and are appointed to geographical areas, known as "divisions". *Special Commissioners* hear and determine the more formal type of tax appeal; they are, in practice, lawyers of considerable experience.
- (d) *Collectors of Taxes.* The Collectors are full-time civil servants appointed by the Board of Inland Revenue. Their principal function is the collecting of taxes charged by the Inspectors. They may issue demand notices, give receipts and distrain upon land and goods where a person fails or refuses to make payment.
- (e) *Board of Referees.* This is a specialist tribunal, consisting of a chairman appointed by the Lord Chancellor, and other members appointed by the Treasury. The Board may act as an appeal tribunal in relation to matters involving certain types of capital allowances.

CORPORATION TAX

The *Finance Act 1965* introduced a corporation tax levied on company profits. A two-tiered system effectively separated the taxation of company profits and the taxation of dividends.

In 1971 a reform of corporation tax was announced, which was

implemented by the *Finance Act 1972*. The new "imputation system" took effect from 1973 and remains the basis of today's corporation tax.

THE IMPUTATION SYSTEM

Under this system a company pays corporation tax at a single rate on all its profits, whether or not distributed. Income tax is not deducted from dividends but where a company makes a distribution of profits to shareholders it is required to make an advanced payment of corporation tax (A.C.T.) to Inland Revenue. The amount of A.C.T. paid by the company is set off against the company's final tax liability at the end of the accounting period. Shareholders who have received dividends in respect of which A.C.T. has been made receive, together with their dividend warrants, a tax credit, so that liability to income tax at the basic rate is satisfied.

Generally, corporation tax which is assessed for an accounting period is payable within nine months from the end of that period.

For purposes of the tax, a "company" includes any body corporate or an unincorporated association; it does not include a partnership or local authority, for example.

Corporation tax is chargeable on the entire profits of companies wherever they arise. A company not resident in is not considered as within scope unless it carries on a trade in the U.K. through an agency or branch.

CAPITAL GAINS TAX

This tax was introduced by the *Finance Act 1965* and is imposed on chargeable gains accruing on the disposal of assets after 6th April 1965. The rate is currently 30 per cent. See *Capital Gains Tax Act 1979*.

CHARGEABLE PERSONS AND CHARGEABLE GAINS

Capital gains tax is chargeable in respect of those capital gains accruing to a person who is resident or ordinarily resident in the U.K. in any year of assessment. In the case of a company—the term includes a body corporate and an unincorporated association, but not a partnership—the charge is to corporation tax and is levied by reference to those chargeable gains accruing to the company during an accounting period.

A person who is not resident or ordinarily resident in the U.K., but who trades through an agency or branch, is generally chargeable on

capital gains accruing to him on the disposal of assets situated in the U.K. and used for trade purposes. Charities, trade unions and local authorities are among the persons and bodies exempted in whole or part from the tax.

EXEMPTIONS AND RELIEFS

In some cases there are exemptions and reliefs for certain kinds of property. Thus an ordinary private motor car is not a chargeable asset; savings certificates are not chargeable assets; sums awarded by way of compensation are not chargeable gains; a gain accruing on the disposal of a chattel which is tangible property is not considered as a chargeable gain if the value of the consideration for disposal does not exceed £1,000; a gain accruing on the disposal of a private residence is not a chargeable gain; generally there is no chargeable gain in the case of the disposal after 19th March 1968 of a wasting asset, *i.e.*, an asset with a predictable life of not more than 50 years. (It should be noted that the term "disposal" has no technical meaning for purposes of the tax; it is construed in its ordinary sense.)

VALUE ADDED TAX (V.A.T.)

V.A.T. was introduced by the *Finance Act 1972*. It is, in effect, a sales tax payable, in the final analysis, by the ultimate consumer.

SCOPE OF V.A.T.

In principle, V.A.T. is chargeable on *all* supplies of goods and services in the U.K. by a taxable person in the course of a business carried on by him, and on the import of goods into the U.K. "Taxable person", usually has the same meaning as "registered person", *i.e.*, one having a turnover currently of not less than £10,000 per annum; it includes individuals, partnerships, companies, etc., and persons who ought to be registered, but who have failed to do so. "Supplies" refers to transactions, *e.g.*, sales, hirings, hire-purchases and the performing of services; services rendered freely are not taxable. "Business" includes any trade, profession or vocation.

ZERO-RATING

A zero-rated supply is taxable, but at a nil rate of tax. In effect, therefore, a registered person who supplies zero-rated services or goods does not have to charge output tax to his consumers; he may, however, recover as input tax any V.A.T. charged to him by his

suppliers. Thus, since exports of goods are zero-rated, an exporter makes no charge of any tax on his export sales; he is able to recover tax he has been charged in respect of taxable supplies. Other zero-rated goods and services include: most types of food, except when used in catering; newspapers, books and periodicals; construction of buildings; medicines supplied on prescription.

EXEMPTION

A person who makes exempt supplies of goods and services has not to charge any output tax to his customers. Unless he also makes taxable supplies, he need not be registered and need not keep tax records. But he is not entitled to recover tax charged on purchases relating to his exempt supplies. Goods and services which are exempt include: land and rents; postal services; insurance; education; finance.

STANDARD RATE

Before the Budget of June, 1979, the standard rate of V.A.T. was 8 per cent. Certain goods were charged at a higher rate of 12½ per cent. Following the Budget, the higher rate was abolished and the standard rate increased to 15 per cent.

SUPPLY OF SERVICES

For purposes of V.A.T. a supply of services includes any service provided for a consideration in money or otherwise. Services provided by employees to their employers are generally outside the scope of V.A.T. Services supplied by the self-employed are generally taxable.

REGISTRATION, CANCELLATION OF REGISTRATION AND APPEALS

Taxable persons are obliged to notify Customs and Excise; they receive a certificate of registration, which advises registration number and tax periods, together with the effective date of registration, from which commence the obligation to pay output tax and the right to deduct input tax.

A registration may be cancelled after a registered person disposes of or closes down his business, or his taxable outputs cease permanently for any other reason. Where a registration is cancelled a final return must be made to Customs and Excise within one month of the date from which cancellation becomes effective.

Independent V.A.T. tribunals deal with appeals about matters such as: registration or cancellation of a registration; assessment of tax; amount of input tax which may be deducted.

CALCULATION AND WORKING OF VAT

V.A.T. is calculated as a percentage of the value of the supply. In general this is the amount actually paid, but excluding V.A.T. itself.

V.A.T. is collected at *every stage* of production and distribution of goods and services; the ultimate consumer bears the final tax. At each stage the taxable person will be charged by his suppliers with V.A.T. on their supplies to him of goods and services relating to his business. Such goods and services are his *inputs*; the tax on them is *input tax*. When he supplies goods and services to his customers, they are his *outputs* and the tax charged on them is *output tax*. On making returns to Customs and Excise, he adds up his output tax and his input tax, deducting the smaller amount from the larger; the difference of the totals represents what has to be paid to Customs and Excise, or what will be repaid to him.

A SIMPLIFIED EXAMPLE OF THE CALCULATION OF V.A.T.

Stage	Basis of business transaction	Selling price (tax not included)	V.A.T. payable	V.A.T. credit	Net Tax paid
		£	£	£	£
1	Importer sells raw material to manufacturer	100	8	—	8
2	Manufacturer sells his manufactured product to wholesaler	225	18	8	10
3	Wholesaler supplies retailer with the product	300	24	18	6
4	Product is sold by retailer to consumer	475	38	24	14

The total paid by the final consumer is

$$£475 + £38 = £513$$

LOCAL TAXATION

Local authorities undertake certain important functions ancillary to those of the Central Government and to carry them out they require large revenues. To varying degrees local authorities have assumed trading functions, particularly those connected with the supply of certain essential services, such as municipal banks, swimming baths and other revenue-yielding undertakings. But, despite such activities, local authorities rely for the bulk of their income on *local rates* and *Exchequer grants*.

Rates *i.e.*, local taxes, are levied upon real property, *i.e.*, upon houses, trade premises and land, the basis being the *rateable value* of such property, which is taken as the rent at which it might reasonably be expected to let free of all the tenant's usual rates and taxes, with reasonable allowances for repairs and insurances.

Rates are paid by the actual occupiers of land or buildings, and they are assessed by the Board of Inland Revenue at so much in the £ on the rateable value. The rate varies from year to year, increasing when the local authority needs further funds and decreasing when expenses are reduced or when the value of property in the vicinity rises. All property is fully rateable except, *e.g.* agricultural property and property used for charitable purposes.

THE BURDEN OF LOCAL RATES

Local rates fail to satisfy the prime canon of equity. That each person should contribute to the costs of local administration in proportion to the value of the property he occupies is a very rough-and-ready basis of computing ability to pay. Its application to commercial concerns is particularly unfair. A jeweller, for example, can occupy a smaller shop than an ironmonger. He might pay lower rates, yet in all probability his profits from the business (and hence his ability to pay) are considerably higher. Again, the size of a factory is no indication of the extent of its profits, *i.e.*, of the ability to pay rates; an engineering works is likely to be larger and employ more workers than a biscuit factory. Moreover, the basis of valuation may not be uniform throughout the area of the precepting authorities.

Even more harmful, however, is the fact that rates increase costs of production. Local rates are imposed on all concerns, whether profits are being made or not. They therefore increase standing charges and so increase costs of production. In particular, they reduce the competitive power of an industry in a highly-rated area as compared with one in a low-rated area. It was to equalise rates as far as possible that the system of *Exchequer Equalisation Grants* was introduced in 1948; in 1959 these grants were replaced by *Rate Deficiency Grants*.

REFORM OF LOCAL TAXATION

A variety of changes has been suggested for reform in the local taxation system. These include: increasing the yield of the rates, *e.g.*, by super-rating non-domestic properties, by surcharges on a householder based on additional amounts for each income-earner living in the household, by site value rating and by the rating of hitherto-ex-

empted agricultural property; obtaining additional revenue from new sources, including local income tax, local sales tax to be levied on retail sales in the locality and local employment tax to be charged on employers and to be based on their payrolls; general improvement of the rating system, including assessments based on capital, and not rental values and a reduction of the period in which properties left empty are free from carrying full rates.

CHAPTER SEVENTEEN

Legal Aspects of Business—IV: Bankruptcy

(In this chapter references unless otherwise stated, are to sections of the *Bankruptcy Act 1914*, which is referred to as 'the 1914 Act'.)

A trading unit may for one reason or another be unable to fulfil its obligations and legal means may be taken so that it can be wound up altogether or granted a sufficient measure of relief to enable it to resume business with some hope of success. The individual trader and the partnership are subject to the laws of bankruptcy and the company is governed by the sections of the *Companies Acts* which deal with liquidation and receivership.

The first signs that the commercial community receives of a trader's actual or impending insolvency are usually a dilatoriness in the payment of accounts and repeated requests for extended accommodation. An efficient concern never allows these signs coming from any of its customers to pass unnoticed, and, as a precautionary measure, it will make careful inquiries—through a bank or an inquiry agency—as to the position of the defaulting concern.

If a customer fails to meet his obligations as they fall due, there are two alternatives open to the creditor. Either he may place the matter in the hands of a debt-collecting agency which specialises in such matters (sometimes the debt may actually be sold for what it is worth and the balance written off), or if the amount is small, a trader might himself take action in the local County Court or place the matter in the hands of his solicitors. The latter will take whatever steps are necessary, resorting, if desirable, to the Courts to obtain settlement. Very often legal action will result in payment being made but in other cases the debtor will acknowledge his inability to meet his debts and will be forced into bankruptcy or (in the case of a company) into liquidation.

BANKRUPTCY

The law of bankruptcy in the United Kingdom is founded on the principle that if a person becomes so insolvent that he is unlikely to be able to meet his obligations it is best for all concerned that, subject to certain conditions, he should be extricated from his position and left free to start again by being relieved of his outstanding debts. At the same time, the debtor's creditors are protected in that any assets

of which he may be possessed are realised and the proceeds distributed according to certain statutory priorities amongst them.

This principle could not be applied in its rough form for that would leave the matter open to abuse: it has therefore been necessary to evolve a complete code governing the manner in which the ex-trication should be accomplished.

The principal Acts of Parliament governing bankruptcy proceedings are the *Bankruptcy Act* 1914, as amended by the Act of 1926 and the *Insolvency Act* 1976. These are supplemented by the *Bankruptcy Rules* 1952.

ACTS OF BANKRUPTCY

Proceedings in bankruptcy cannot be commenced until the insolvent debtor has committed an *act of bankruptcy*, which he does in any of the following circumstances, as set out in the 1914 Act, s. 1 (1):

- (a) If he makes a conveyance or assignment of his property to a trustee for the benefit of his creditors generally. A petition cannot, in general, be based on this act by a creditor who has assented to the conveyance.
- (b) If he makes a fraudulent conveyance gift, delivery or transfer of his property, or of any part thereof.
- (c) If he makes any conveyance or transfer of his property, or any part thereof, or creates any charge thereon which would be void as a fraudulent preference if he were adjudged bankrupt.
- (d) If, with intent to defeat or delay his creditors, he departs out of England and Wales, or being out of England and Wales remains out, or departs from his dwelling-house, or otherwise absents himself or begins to "keep house" (*i.e.*, shuts himself indoors and makes himself inaccessible).
- (e) If execution against him has been levied by seizure of his goods, and the goods have been either sold or held by the sheriff for twenty-one days.
- (f) If he files in the court a declaration of his insolvency, or presents a bankruptcy petition against himself (see below).
- (g) If a creditor has served on him a bankruptcy notice under the Act, and he does not, within seven days, either comply with the requirements of the notice, or satisfy the court that he has a counter-claim which equals or exceeds the amount of the judgment debt, and which he could not have set up in the proceedings which led to the judgment or order on which the bankruptcy notice was based.

A *Bankruptcy Notice* is one issued out of court and served upon a judgment debtor by the judgment creditor, requiring the former to pay the debt in accordance with the terms of the judgment or to secure or compound for it to the satisfaction of the creditor or of the court, and stating the consequences of non-compliance.

- (h) If the debtor gives notice to any of his creditors that he has suspended or is about to suspend payment of his debts.

OTHER ACTS OF BANKRUPTCY

Other statutory provisions may result in an act of bankruptcy being committed by a debtor, for example:

- (a) Under the 1914 Act, s. 107 (4), where a judgment creditor applies to a Bankruptcy Court under the *Debtors Act* 1869, s. 5, for committal of the judgment debtor, the Court may, if it so wishes, decline to commit and, with the judgment creditor's consent, may make a receiving order against the debtor. The debtor is deemed to have committed an act of bankruptcy at the time the order was made.
- (b) Under the *Powers of Criminal Courts Act* 1973, s. 39 (5), a debtor commits an act of bankruptcy when a criminal bankruptcy order is made against him.
- (c) Under the *Insolvency Act* 1976, s. 11 (1), where a person fails to make a payment which he is required to make under an administration order, the Court may, if it thinks fit, revoke that order and make a receiving order against that person. Under s. 11 (5), the person is deemed to have committed an act of bankruptcy at the time the receiving order is made.

BANKRUPTCY PETITION

Once a debtor has committed any of these acts, a creditor may take proceedings to have him declared bankrupt. The first step is the filing of a *bankruptcy petition* founded on the specific act of bankruptcy. The petition is presented to the relevant court (see above) by a creditor or creditors, or by the debtor himself, and asks that a *receiving order* be made. The following conditions must be fulfilled before a petition may be filed:

- (a) The debt due to the petitioning creditor (or to two or more creditors if the petition is presented jointly) must amount to £200 at least (but a bankruptcy notice may be issued in respect of any amount).

- (b) The debt must be an ascertained or liquidated sum, payable immediately or at some certain future time.
- (c) The act of bankruptcy relied upon must have been committed within three months previous to the presentation of the petition.
- (d) The debtor must be subject to the bankruptcy laws of England and this, generally speaking, depends upon present domicile here, or ordinary residence or carrying on business here within a year before the presentation of the petition.

In addition, the debt upon which the creditor petitions must have existed at the date on which the act of bankruptcy was committed.

The petition must be verified by affidavit and a copy must be served on the debtor where the petition is not his own. After an interval of not less than eight days from the date of the service the Court will hear the petition, and at the hearing will require proof of the existence of the debt, of the service of the petition and of the act of bankruptcy. It will then make a receiving order or dismiss the petition, as it thinks fit. Once presented, a petition can be withdrawn only by leave of the Court.

THE PROPER COURT IN WHICH TO PRESENT PETITIONS

The 1914 Act, s. 98, sets out instructions concerning the appropriate court in which to present a petition. The High Court is the proper court in those cases in which a debtor, by or against whom a petition is being presented, has resided or carried on business within the London Bankruptcy District for the greater part of the six months immediately preceding presentation of the petition, or for a longer period of time during those six months than he has resided in any County Court district.

Wherever a debtor is not resident in England, or if the petitioning creditor cannot ascertain his residence, the petition must be presented to the High Court. In other cases a petition is presented to the County Court for the bankruptcy district in which the debtor has resided or carried on business for the longest period of time during the six months immediately prior to the presentation of the petition.

RECEIVING ORDER

When the Court makes a receiving order, a copy is served on the debtor and notice thereof is published in the *London Gazette*. The effect of the receiving order is to constitute the Official Receiver (a permanent official of the Department of Trade) the receiver of the debtor's property. Immediately the order is made, all legal processes against

the debtor or against his property are automatically stayed. The Official Receiver takes charge of the assets and affairs of the debtor and acts as temporary trustee.

STATEMENT OF AFFAIRS

When a receiving order is made against a debtor he is saddled with certain responsibilities, the first of which is the preparation of a *statement of affairs*. This must be verified by affidavit and must be filed within seven days of the receiving order (three days if the debtor presented the petition himself). The statement must contain the following particulars:

- (1) A statement of his assets and liabilities, showing the amount of his deficiency.
- (2) The names, addresses and occupations of his creditors showing the amount due to each and the security held (if any).
- (3) An account showing how the deficit has been produced.

Any creditor may inspect the statement and make copies or extracts therefrom.

EXAMINATION OF THE DEBTOR

The court may, at any time after a receiving order has been made, summon before it the debtor, or his wife, or other persons known or suspected to possess any of the debtor's property. Documents may be ordered to be produced at this private examination. The debtor and other persons are examined on oath. A second, public examination is held in open court as soon as possible after the expiration of the period for presentation of a statement of affairs.

The debtor is required to answer upon oath, at the public examination, all questions put to him by the Official Receiver and creditors relating to his conduct, property and dealings. He is obliged to attend this examination and failure to do so may result in his arrest.

On grounds of the debtor's physical or mental unfitness to undergo public examination, the court may excuse his attendance. Under the *Insolvency Act 1976*, s. 6 (1), the court may make an order dispensing with public examination, in the exercise of its discretion, having regard to all the circumstances of the case and, in particular, whether the debtor has made full disclosure of his affairs, the number and nature of his debts, whether he has been adjudged bankrupt previously and whether his bankruptcy might be a matter of public concern.

COMPOSITION OR SCHEME OF ARRANGEMENT

At any time after the receiving order and within four days of delivery of his statement, the debtor may submit proposals for a *composition* in satisfaction of his debts (*i.e.*, the offer of so much in the £) or a *scheme of arrangement* of his affairs. Such a scheme or composition will be considered by the creditors at their first meeting, or at a meeting called for the purpose, and, if adopted by a majority in number representing three-fourths in value of creditors who have proved their debts, it will go up for consideration by the court. The Official Receiver will report to the court upon the conduct of the debtor and upon the proposed scheme. If the court sanctions the scheme, it becomes binding upon all the creditors; and, if the debtor carries out his promises, he is released from all further liability in respect of the debts.

DEEDS OF ARRANGEMENT

A deed of arrangement, which must be carefully distinguished from a scheme of arrangement, may be made in any of the forms specified in *Section 1* of the *Deeds of Arrangement Act, 1914*, and the *Deeds of Arrangement Rules, 1925*. If such an instrument is:

- (a) for the benefit of creditors generally or
- (b) for the benefit of three or more creditors of an insolvent debtor,

it must be *registered* as a deed of arrangement and must receive the assent of a majority in number and value of the creditors. The deed is not, however, binding on creditors who do not assent.

A deed of arrangement will be void for want of registration, for want of assent of a majority of creditors, or upon the making of a receiving order upon a petition presented within three months after the execution of the deed.

Usually, the deed conveys the whole of the bankrupt's business property to a trustee for administration on behalf of his creditors. The trustee is not in such a strong position as a trustee in bankruptcy, but provided he takes care to get the consent of all the creditors he can fairly safely administer the property.

The object of a deed of arrangement is to give the creditors the benefit of the debtor's property without the publicity, formality and delay involved in bankruptcy proceedings. The former procedure is also more elastic and does not stigmatise the debtor so seriously as does bankruptcy.

MEETING OF CREDITORS

In order that the bankruptcy may be conducted with the full knowledge and consent of the creditors, meetings of the latter are held from time to time. The first meeting of creditors is held within fourteen days after the date of the receiving order, and the debtor must attend to give information. Seven days' notice of the meeting is given in the *London Gazette* and in a local paper. The Official Receiver calls the meeting and presides, but at any subsequent meeting the creditors choose their own chairman. At the first meeting all creditors may attend, but no person is entitled to vote unless he has proved his debt, and the proof has been duly lodged.

The creditors may decide at this meeting to accept a *scheme* or *composition*, or they may resolve that the debtor be adjudged bankrupt by the court. In the latter case the court will adjudge the debtor bankrupt, and in any case it will do this if it cannot approve the scheme of composition (if any) or if the creditors at their first meeting pass no resolution at all. If the creditors resolve on adjudication they may elect a *trustee* and a *committee of inspection*.

Subsequent meetings may be arranged if necessary, but very often the first is the only one.

ADJUDICATION

At this stage the debtor has not been judicially declared bankrupt, but after the first meeting a new phase begins. The debtor will be adjudged bankrupt by the court in the following cases: *a* where the creditors resolve that he shall be so adjudged; *b*, where they pass no resolution; *c*) where they hold no meeting; *d*) where the debtor fails to give a proper account of his affairs; *e*) where a scheme of arrangement or of composition falls through; *f*) where the debtor has absconded; *g*) where the public examination is adjourned indefinitely; *h*) where the debtor requests it at the time of the receiving order; *i*) if default is made in payment of an instalment due in pursuance of a composition or scheme, or if it appears to the court that approval of the composition or scheme was obtained by fraud.

The effect of the court's order of adjudication is to constitute the debtor a bankrupt, depriving him of his property and vesting it in a *trustee in bankruptcy* who must be appointed for this purpose.

THE OFFICIAL RECEIVER

Pending the appointment of the trustee the Official Receiver will act as trustee. His duties are many and varied. He must act as trustee not

only pending the appointment of the latter but also during any vacancy in the office. He has to preside at the first meeting of creditors and to conduct the debtor's public examination. It is his duty, too, to maintain a careful supervision over the bankruptcy proceedings, and to see that proper accounts are kept. Further, he must arrange for the publication and circularisation of notices and must keep the creditors informed of any proposals of the debtor in respect of the proceedings and his affairs. Finally, he must, if necessary, institute criminal proceedings against the bankrupt if the latter has committed any criminal offence in respect of his assets.

THE TRUSTEE IN BANKRUPTCY

The trustee is usually appointed by the creditors, or by a committee of them, subject to the approval of the Department of Trade. Before he can take up his position his appointment must be confirmed by the Department, which will require him to give security. His remuneration is generally fixed by the creditors, and must take the form of a percentage on: (a) the amount realised by the trustee himself, and (b) the amount distributed in dividend. Often the trustee is an accountant.

The duties of the trustee are to realise the assets as rapidly and profitably as possible, to keep accounts of all his transactions and to distribute the proceeds among the creditors according to their rights. In all matters he must endeavour to carry out the wishes of the creditors and must obey the instructions of the Department of Trade.

The trustee may be assisted, in some cases, by a *committee of inspection*, elected by the creditors from among themselves, and he must then be guided throughout by their decision.

Sometimes the creditors request the Official Receiver to appoint a *special manager* to carry on the debtor's business. Like the trustee, he must give security as directed by the Department and must keep proper accounts.

PROOF OF DEBTS

To share in the distribution of the bankrupt's property a creditor must "prove" his debt. This he does by furnishing the trustee with proof of the existence of the debt, verified by affidavit, whereupon the trustee may either accept the proof or reject it. In the latter case the presumptive creditor may apply to the Court for revision of the trustee's decision. A creditor may prove for "all debts and liabilities, present or future, certain or contingent, to which the debtor is subject to him at the date of the receiving order, or to which he may become

subject before his discharge by reason of any obligation incurred before the date of the receiving order”.

In making his proof the creditor may claim interest up to the date of the receiving order if the debtor has agreed to pay such interest. But not more than 5 per cent per annum can rank for dividend till all creditors have been paid in full, any excess interest ranking as a deferred claim. Apart from interest arising out of a special contract with the debtor, $7\frac{1}{2}$ per cent per annum to the date of the receiving order is allowed on judgments.

DISTRIBUTION OF ASSETS

As and when the trustee realises the property or so much as is readily realisable, he proceeds to distribute the proceeds by payment of dividends to the creditors of so much in the £. Before he is able to distribute any of the proceeds to the ordinary creditors he has to cover his expenses and pay off the claims of preferred creditors.

The order of distribution of assets is as follows:

- (1) *Expenses* actually and properly incurred in connection with the bankruptcy proceedings.
- (2) *Pre-preferential debts*. Thus, if the bankrupt was an official of a friendly society or a savings bank, under this heading will be included any monies or property of such an association. Under this heading is also included any claim for expenses of the trustee of any deed of arrangement avoided by the debtor's bankruptcy. Any premiums paid by clerks or apprentices as fees may be repaid by the trustee to the extent he considers reasonable. It should be noted that under the *Employment Protection Act* 1975 the Secretary of State shall, upon application by an employee, pay to him from the Redundancy Fund, such an amount as the trustee in bankruptcy considers reasonable by way of reimbursement of premiums, etc. Thereupon, the employee's rights and remedies in relation to that debt are transferred to the Secretary of State.
- (3) *Preferential debts*. Under this heading come, for example, rates, income tax assessed on the bankrupt up to the fifth day of April next before the date of the receiving order and debts in relation to the *Social Security Act* 1975. Employees' wages in respect of services rendered to the bankrupt during four months before the date of the receiving order, not exceeding £800, come under this heading. Following the *Employment Protection Act* 1975, certain payments have become preferential debts for purposes of distribution of assets: they include guarantee payments, remuneration relating to suspension on medical grounds, payment for time off and remuneration under a protective award.

- (4) *Ordinary debts.* When the trustee has paid in full debts in categories (1)–(3) above, he is obliged to apply funds which remain to the payment of debts owing to ordinary creditors, all of whom are considered as standing on an equal footing. The ordinary debts abate together so that available funds are distributed among the ordinary creditors in proportion to the claims they have proved. “Postponed creditors”, whose claims are postponed until the claims of all pre-preferential, preferential and ordinary creditors have been settled in full, include, *e.g.*, the bankrupt’s spouse (in relation to money loaned unsecured for use in the business).

Under the 1914 Acts, s. 69, the bankrupt is entitled to any surplus remaining after full payment of all costs and expenses and full payment with interest to creditors.

SECURED CREDITORS

A secured creditor is one whose debt is secured by a mortgage, charge or lien on some part of the bankrupt’s property, and when proving his debt he has four courses open to him. He may rely on his security and not prove at all; or he may realise the security and prove for the balance of his debt; or he may surrender his security and prove for the whole debt; or he may value his security in his proof and prove for the balance of his debt. Where, however, a creditor of the bankrupt has received security in the form of a charge on the assets of some person *other than the bankrupt*, he may prove for the whole of his debt and need not deduct the value of his security.

DISCHARGE OF A BANKRUPT

A person who has been adjudged bankrupt and has not yet been granted his discharge is known as an *undischarged bankrupt* and is subject to certain restrictions. Thus he is guilty of a misdemeanour if he obtains credit, either alone or jointly, to the extent of £50 or more, without disclosing the fact that he is an undischarged bankrupt. Moreover, it is an offence for him to trade in a name other than that under which he was adjudicated, unless he first discloses the fact that he has been adjudicated and reveals the name under which the adjudication was made.

It is obvious, therefore, that a bankrupt’s prime object must be to obtain his *discharge*, releasing him from his liabilities. This can be obtained by application made to the court at any time, but the application cannot be heard until after the conclusion of the public examination for an order of discharge. Fourteen days’ notice must be

given to all the creditors who have proved in the bankruptcy, and the application for discharge may be opposed by any creditor, or by the trustee, or by the Official Receiver.

There are five kinds of discharge: (a) *conditional*, i.e., subject to certain conditions, in which case, if the debtor fails to fulfil the conditions, it may be revoked; (b) *suspensive*, i.e., after a fixed time; (c) conditional and suspensive; (d) immediate; (e) automatic.

The order for a debtor's discharge may be refused by the court in certain circumstances, and in others may be suspended for a fixed period, or until the bankrupt has paid a dividend of, say, 50p in the £, or it may be granted subject to the debtor's consenting to judgment being entered against him for any part of his unpaid provable debts.

There are, however, certain debts provable in bankruptcy from which a debtor is not discharged unless the court orders otherwise, e.g., judgment debts, in affiliation or matrimonial proceedings.

Generally speaking, it may be said that a discharge will be refused only when the bankrupt has committed a bankruptcy offence. Certain of those offences, such as concealment of assets or falsification of books, are criminal and are punishable by imprisonment; others, such as failure to account for assets, are not criminal but may result in refusal of a discharge.

Modifications in the law relating to the discharge of a bankrupt have been made by the *Insolvency Act* 1976. Under s. 7, the bankruptcy court is empowered, at the time of the declaration which concludes the debtor's public examination, to make an order which has the following effect: if the debtor is not discharged by virtue of the 1914 Act, s. 26, e.g., as where a dividend of over 50p in the £ is paid, before the fifth anniversary of the date of adjudication, and if the adjudication has not been annulled before that anniversary under the 1914 Act, s. 21 (2) or s. 29, then the debtor *shall automatically become discharged* on the fifth anniversary of the adjudication. Under s. 7 (4) there is introduced a retrospective discharge of all bankrupts whose adjudication took place more than 5 years before s. 7 came into force.

Section 8 of the *Insolvency Act* 1976 has application to all cases of adjudication which were made after, or within 5 years before, the coming into force of the Act and in which the bankrupt has not made application for discharge under the 1914 Act, s. 26, and the adjudication has not been annulled and no order relating to automatic discharge under s. 7 has been made. In such a case, when five years have passed since the adjudication date, the Official Receiver must, within one year of the anniversary of the adjudication, make application to the court in respect of the adjudication. The court will con-

sider the bankrupt's conduct and affairs; it is empowered to grant or refuse an absolute order of discharge, suspend a discharge or grant a conditional discharge.

WINDING-UP

We have considered how the insolvent individual can be relieved of his liabilities when he is financially overwhelmed. Similar procedure applies in the case of limited companies. In Chapter 4 it was pointed out that a company could be wound up compulsorily by the court when it was deemed unable to pay its debts. This is parallel to bankruptcy. In place of the trustee, the *liquidator* acts on behalf of the creditors. Of course no public examination of a company can take place, but the court may examine any director, promoter, etc., of a company where there appears to have been fraud. In compulsory liquidation proceedings, a *winding-up order* takes the place of a receiving order and an adjudication order, and in place of discharge there is an *order for the dissolution* of the company. Slight complications are involved by the necessity, sometimes, of making *calls* on the shareholders for capital not yet paid up, and by the fact that any surplus must be distributed among shareholders, whose rights *inter se* must be adjusted. In broad principles, however, liquidation is similar to bankruptcy and it is unnecessary to consider it in greater detail here. A company may, of course, be wound up for reasons other than insolvency, *e.g.*, to bring the company to an end whilst still solvent or to amalgamate its business with that of another company. In such cases the members meet and pass a resolution putting the company into *voluntary liquidation*. If the directors have been able to make a *declaration of solvency*, *i.e.*, a declaration that the company will be able to pay its debts in full within twelve months, the liquidation will proceed as a *members' voluntary winding-up*, the creditors having no part in it. Otherwise it proceeds as a *creditors' voluntary winding-up*, the creditors if they wish appointing the liquidator and committee of inspection. The company comes to an end automatically and is deemed to be dissolved three months after the liquidation proceedings have terminated.

Part II

*MARKETS, RISK-BEARING AND
INSURANCE*

CHAPTER EIGHTEEN

Markets and Commodity Exchanges

MARKETS

Markets are places where buyers and sellers meet to exchange goods or services. Although there are many markets which deal with a multitude of different commodities, there is a general tendency for sellers of the same commodity to congregate in a common market place, for their own convenience as well as for that of their customers, *e.g.*, the meat market, the fish market and the vegetable and fruit market.

MARKETING BY SAMPLE

As the variety and value of goods increase and the quantity of each type of product grows, it becomes increasingly difficult to display the whole stock offered for sale. Nor is it always necessary for the purchaser to see the goods before he buys; it is possible in many cases to place an order on the basis of a sample which he knows will conform to the characteristics of the goods represented. Sales by sample are usual in branches of the textile and fabric trades and, to some extent, in the grain trade.

The sample is more easily and economically handled than the bulk and by its use the bulk can be disposed of in a distant market without being inspected by the purchasers. An enormous gain in time, energy and money accrues in this way.

Selling by sample is not usual in manufactured goods, though the increasing standardisation of products, together with the system of brand names, enables a buyer to know that he can repeat an order for a branded good and be sure that it will be of the same standard as his original purchase.

MARKETING BY GRADE

This is a development of sale by sample, applying particularly to raw materials that can be conveniently classified according to quality. In the produce markets the raw materials are graded by independent authorities according to fixed standards, so that the quality of any commodity is immediately recognizable *from its description alone*, and the buyer knows exactly what to expect. Whole cargoes, or even crops, of the raw product change hands many times on the simple assurance that on delivery they will conform to a certain specified grade.

THE ADVANTAGES OF GRADING

First, there is the advantage that, with quantity, size and quality fixed or determinable, price is the only variable factor. Secondly, grading makes sale by inspection and sample easier, since fewer samples are needed and these samples conform more closely to bulk than do samples of goods which are not graded. Where grading exists, it is not necessary to distinguish commodities produced at different times and places if the various lots each fulfil the characteristics of the same grade. Thirdly, grading makes possible dealings for future delivery, as, for example, in the cotton markets where the methods have reached a high degree of perfection. Fourthly, financing becomes a simpler and cheaper process, for not only can prices be more easily determined and fluctuations more certainly followed and forecasted, but also banks are more willing to grant loans against the security of goods whose exact quality is known or ascertainable. Finally, the development of grading widens the market and facilitates the dissemination of accurate market knowledge.

Grading is important in the retail as well as in the wholesale trade. Branded goods are sold in standardised packages and the retailer is in effect an agent satisfying demands which arise out of extensive advertising by producers. This reduces the price paid by the consumer as the number of inspections and, therefore, the cost of inspection are reduced.

HOW THE MARKETS ARE RELATED

The simple examples of the production and marketing of the materials contained in a cotton dress and of the dress itself will illustrate the manner in which the various markets are interrelated. The raw cotton is grown in the United States of America, passed through the collecting centre at Memphis and transported to, say, Liverpool. The spinner in Britain buys the cotton and converts it into yarn; the yarn is transferred to a weaving shed and woven into cloth. The material produced is then made up into a dress by a manufacturer and sold by him to a wholesaler, who in turn sells it to a retailer, from whom it is bought by the consumer. *At each stage there is a separate market*, some of the markets being highly organised.

This intricacy of the marketing process involves a problem which is of vital importance to both producer and consumer—the high cost of the marketing function. The magnitude of distribution expense creates a great difference between the prices received by producers and those paid by consumers and unless marketing is performed cheaply and efficiently, it fails to fulfil its primary object and is merely a burden to the community.

MARKETS FOR RAW MATERIALS

Most of the markets for raw materials—the *produce or commodity markets*—are conducted on the basis of samples and grades. Each of these markets is centralised or localised in some important city, though it embraces practically the whole world in the course of its operations. There are various reasons why the world's most important cotton exchanges became situated in Liverpool and Manchester, and why Mincing Lane became the centre of the world's markets for rubber, tea, coffee, tea and other commodities. Custom, control over raw materials, concentration of demand for raw materials, the situation of a port or an important trade route and similar influences were important factors in this well-marked localisation.

The commodity markets provide highly developed facilities not only for the gathering together of buyers and sellers, but also for fixing prices, grading commodities and the publication at frequent intervals of market reports containing particulars of prices, quantities sold and other information. The prices are published in Market Lists and in national newspapers. Reports on the business effected in the markets are usually issued daily or at other convenient intervals, the operating dealers being themselves responsible directly or indirectly for the collation and preparation of valuable information concerning crops, raw material production and existing stocks—information which does much to steady market operations, to facilitate transactions and to minimise the risks of business to traders and producers, who, by carefully studying market reports and prices, are able to estimate future price movements.

In most of these markets there is a central exchange at which dealers meet, but business generally is transacted over the telephone.

A market does not, therefore, necessarily imply a localised market place and it can be defined as "*a commodity or group of commodities and the buyers and sellers thereof who are in direct contact with one another*". In other words, the term "market" refers to a set of *conditions* involving a commodity and the persons dealing with it.

CONDITIONS OF A WIDE MARKET

The conditions which must be fulfilled by a commodity dealt with in a *wide market* may be summarised as follows:

- (a) *Extensive demand, i.e.,* many buyers. The market in wheat is wider than that in diamonds because wheat is in greater demand.
- (b) *Portability of the commodity.* Bulky articles of low value, *e.g.,* bricks and sand, unless they are of prime necessity, as for in-

stance fuel, have local markets because the cost of transporting them over long distances is prohibitive. Gold, diamonds and silk are easily carried and have world-wide markets.

- (c) *Suitability for grading, sampling and exact description*, so that the bulk can be sold by letter or cable throughout the world, without the possibility of misunderstanding or doubt. Cotton and wheat can be so sold; cattle obviously cannot be bought without inspection.
- (d) *Durability of the commodity*. Perishable and fragile articles cannot be transported over long distances and are therefore sold in local markets. Also the market in perishable commodities is limited as to time. In the case of fresh strawberries, for instance, prices are determined by prevailing supply and demand conditions.
- (e) *Extensive supply*. Only a very restricted market can exist in commodities such as antiques, curiosities and works of art, the supply of which is limited.

To sum up: *the markets for non-perishable necessities of life are generally world-wide; the markets for other commodities are usually narrow.*

MARKET PRICE

If perfect conditions are assumed to exist in any market, no buyer will pay more for any given article than any other buyer is required to pay. And it must follow that, so long as the buyer gets what he requires, he is indifferent as to who supplies it. Thus, if the price asked by one seller is lower than that asked by others, then all the buyers will desire to purchase from that seller. In like manner, no seller will willingly dispose of an article at a lower price than that obtained for the same article by any other seller; if one seller obtains a certain price, all others sellers tend to hold out for at least as good a price.

It may be concluded, therefore, that *in the same market, at the same time, there tends to be only one price for the same commodity*. By the same commodity is meant one of exactly similar quality and character, any unit of which will be used or held indifferently in place of an equal unit.

There can however be spatial differences in price at the same time owing to the different transport costs from the points of supply to the different selling points.

COMMODITY MARKETS

MARKET ORGANISATION

The organisation of all commodity markets or exchanges is basically the same. In each exchange traders are brought together for the transaction of business and dealings are conducted on carefully defined lines so that they may be carried through with a minimum of formality and trouble. Membership of most exchanges is exclusive; a high standard of business integrity is maintained, and the interests of the public are adequately protected.

The committees of the various exchanges do useful work in governing the conduct of the markets. Careful attention is paid to the grading of the commodities dealt in. In some markets only samples of consignments are displayed, whilst in others the whole world's production of the particular commodity concerned is marketed simply by grade. Some commodities lend themselves better than others to certain methods of marketing, and the nature of the commodity determines the procedure of the market.

Some exchanges have a central hall or mart in or around which are the offices of the members. Trading may be carried on in the hall but in most cases it is done by dealers and brokers in private offices or over the telephone.

EXCHANGE TRANSACTIONS

The exchange is the meeting-place of members, who may be dealers acting on their own account or brokers buying or selling for the account of their principals. Every transaction is embodied in a *Contract Note*, which is exchanged between buyer and seller, but the note is not made out when the bargain is made. At the time of dealing, as a rule, very little formality is observed. After one or two brief remarks a price is agreed, and the essentials of the contract are jotted down in a notebook. The contracts are made out later by the clerks of the respective dealers and are agreed by comparison.

In general, transactions may be divided into two broad classes: (1) those for *immediate* delivery, and (2) those for *future* delivery.

Dealings in the *spot* market (*i.e.*, for immediate delivery) are concerned with existing stocks. Samples of the stocks are examined at the warehouses or in the offices of brokers or, perhaps, on the exchange itself, and bargains are concluded for immediate delivery of the goods. In appropriate instances the goods will be sold by grade without the production of samples. Much of this class of business is conducted in the private offices of dealers or by telephone.

Trading in *futures* is in crops and commodities not yet available.

Clearly, this can only be on the basis of description or recognised grades. It is done (a) as a form of speculative investment; and (b) by manufacturers anxious to secure their sources of supply in advance to ensure uninterrupted production.

MODE OF SALE: AUCTIONS

The actual mode of sale depends primarily on the nature of the commodity. Generally speaking, it may be stated that the ideal mode of disposing of goods is by dealing on 'Change. But this mode of sale is suitable only where the goods can be suitably graded and described, for it would obviously be impracticable for a selling broker to perambulate the exchange with a sample hide seeking a likely buyer, and he could not carry round a whole shipment of hides. Some other method of sale must be adopted where the goods are unsuitable for sale by grade or description, as is the case with such commodities as tobacco and wool. In the case of wool, for instance, difficulty has been experienced in grading. The problem has been solved by the institution of the *auction sale* where prospective buyers have the opportunity of inspecting and sampling the goods before they offer to buy.

The auctions are held at fairly regular dates, coinciding with the times supplies of the commodities are available.

To be suitable for sale by auction, the commodity must be in wide demand in order to attract a large number of buyers, and supply should be concentrated in a few centres. The commodity need not be capable of a high degree of standardisation into grades, although *some degree* of standardisation is desirable.

The procedure adopted is the same in principle for all commodities. Sale catalogues are circulated among possible buyers, and opportunity is provided for the inspection of samples and, in some cases, of the actual goods. Terms of sale, deposit requirements and brokerage are fixed by each trade association and must be observed if the contract is to be recognised by the association.

Some goods are sold by private bargaining—not by grade or by auction—and it will usually be found that such goods are sold in this manner either because they are too perishable to be held over for an auction or because they have too limited a market to justify the arrangement of special sales. It may be noted that even the most perishable commodities are frequently sold in local auctions, *e.g.*, fish, fruit and vegetables.

Clearly, the grading and standardisation of goods are of the greatest advantage in determining the mode of sale. Where accurate grading is possible, the goods are suitable for exchange dealings, and

what is more important, dealings in futures are possible. But it is essential in all attempts at grading that the grades shall be sufficiently accurate to prevent misunderstanding.

CLEARING HOUSES

As a result of the development of dealings in futures, the world's harvest of wheat or cotton can be sold over and over again, but, through the various clearing houses run by the exchanges, purchases and sales by members are cancelled out so far as is possible and only "differences" are settled.

Produce clearing houses are of great service to members; their chief objects are:

- (1) The elimination of all intermediaries in a series of contracts and the bringing together of the first seller and the last buyer.
- (2) The settlement of differences caused by changes in prices.

GRAIN

Most of the import business in grain is carried on at the Baltic Mercantile and Shipping Exchange at St Mary Axe, London, with brokers acting as intermediaries between importers and merchants. Almost all the business is on the basis of *c.i.f.* (cost, insurance and freight) contracts of grain "to arrive". Spot transactions, however, take place on the Corn Exchange in Mark Lane. As a rule, members of this exchange are also members of the former, the procedure being to contract for cargoes of grain on the Baltic and sell "spot" on the Corn Exchange.

Wheat is graded according to quality, the latter being determined largely by the country of origin and by certain other characteristics, *e.g.*, hard and soft wheats are distinguished.

The form of contract on the Baltic Exchange usually includes the stipulation that the grain should be of *fair average quality* (f.a.q.) of the season's growth. The grading of wheat to establish this fair average quality is determined by the London Corn Trade Association, whose representatives obtain samples of all cargoes in the recognised shipments. Since cargoes vary considerably and contracts are nearly all on the basis of fair average quality, it is frequently necessary to adjust differences. Thus, an allowance is made to a buyer who has to take cargo below standard, but no allowance is made for cargoes above standard.

On the Mark Lane Corn Exchange transactions are mostly for spot. The goods, which include beans, cereals, peas and seeds of all

kinds, are sampled by cargo superintendents or at the warehouse. Samples of the cargoes on board ship or in warehouse are exhibited by the members at their stands, and on that basis transactions are effected.

Home-grown grain is sold to a number of exchanges situated in the grain-growing areas.

COTTON

The principal market for the distribution of cotton to the Lancashire mills is the Liverpool Cotton Exchange. There are no auctions in this market as in the wool, tea and other produce markets; perhaps its most important feature is the large amount of business done in futures.

Cotton lends itself to an elaborate system of grading, according to differences in growth and quality. Transactions are carried out in terms of the various grades, indicated by reference to the place of origin, *e.g.*, *North American*: Sea Island, Florida Sea Island, Upland, Orleans and Texas; *Egyptian*: Egyptian brown, Egyptian white.

The cotton is also classified as to quality.

TEA

Tea is sold by auction at the Tea Trade Centre, London. Some large tea-blending firms import through Manchester, but the bulk of the tea imported into England at the instance of the growers or their agents or of importing merchants and warehoused pending its sale.

The actual buying and selling of the tea is transacted almost entirely between brokers, selling brokers acting for the importers and buying brokers acting for most buyers. The auction sales, held three times every week, are public, and there is a certain amount of direct buying; but apart from the advantage of employing the brokers' expert skill and experience, many purchasers prefer to remain anonymous.

The importer of a consignment of tea notifies his broker and commissions him to effect a sale. The broker lists the various lots and prepares a catalogue according to grades, weights and trade descriptions. For this purpose, and also in order to form an estimate of the prices he ought to obtain, he gets samples of the tea from the warehouses in which it has been placed. Sampling is a necessary function of brokers and of many merchants too; and for this reason the Tea Brokers' Association annually grants to brokers and other duly accredited firms authority to obtain samples.

When the selling broker has sampled the teas and estimated their

values he prepares his catalogue and sends it to his prospective purchasers. The catalogue contains full particulars of the packages, descriptions and weights, and mentions the warehouse where the tea is on show where it might be sampled, and the date of auction. As each lot is put up for sale, the buyers bid in competition.

After the sale the selling broker sends his principal a contract note stating to whom he has sold the tea and at what prices, and at the same time he sends to the buying broker a *weight note* containing a copy of the details on the warehouse warrant, the price at which the sale was effected, the total amount payable, the deposit required immediately, and the amount remaining to be paid on or before "Prompt Day", generally four months later. When the buyer pays the balance of the purchase money he is given the warehouse warrant in exchange.

WOOL

Wool is another of the commodities which are sold by auction. It is marketed through several centres, of which London and Bradford are the most important. Since most imported wool is sold at the Wool Exchange in London, a description of the marketing process there will be sufficient.

Special wool warehouses are maintained by the Port of London Authority and by private firms, where the importers arrange to have their consignments stored. The wools that have arrived in time for each series of auctions are entrusted to the constituent firms of the London Wool Brokers Ltd. The selling brokers obtain from the importers "sampling orders", which enable them to procure from the warehouses samples of various bales. These they examine and then give instructions to the warehouses for the bales to be graded accordingly. The brokers then proceed to prepare their catalogues on the basis of the samples and arrange the day of the sale. Prior to each sale, the bales are on view to buyers at the warehouses. The buyers meet in the sale-room and the sales are conducted in eight annual series by a small number of firms of wool brokers, who possess a very highly specialised knowledge of the commodity and the market.

A *Wool Futures Market*, controlled by the London Wool Terminal Market Association, gives brokers a chance to buy or sell up to eighteen months ahead. Trading in futures has declined in recent years as the direct result of competition from trade in synthetic fibres.

DIAMONDS

Most of the world's diamonds, which are produced mainly in South

and South-West Africa are traded on the London Diamond Market at Hatton Garden, around which most dealers' premises are located. Gem diamonds are sold by firms such as the Diamond Trading Company, Ltd; industrial diamonds are sold by organisations such as the Industrial Diamond Company (Sales) Ltd. The principal buyers represented on the market are based in Israel, Belgium and the U.S.A. Diamond "sights" are conducted ten times every year. Dealers submit their requirements and indicate the prices they are prepared to pay. The diamonds are made up into parcels and allocated to prospective buyers who may accept or reject after inspection at the "sights". The contents of the parcels are afterwards sold to firms whose representatives may not be present at the inspection of the stones.

METALS

The London Metal Exchange is located in Whittington Avenue. Six hundred members trade in copper, tin, zinc and lead. Dealings are conducted daily. Each metal is traded in turn, usually in multiples of 25 tons (25·4 tonnes) for lead, zinc and copper and of 5 tons (5·08 tonnes) for tin. Offers and bids are made by "outcry", the verbal deals being recorded by dealers' clerks.

RUBBER

The London Rubber Exchange operates in Mark Lane and is conducted by the London Rubber Trade Association which represents producers, brokers and dealers. Dealings may be made verbally on the premises of the Exchange, or in brokers' offices, or by telephone; contracts must be made through recognised brokers. Contracts are based on Standard Ribbed Smoked Sheet or Standard Malaysian Rubbers; inspection of samples precedes the issue of certificates of quality. Dealers make fortnightly settlements of their margins, *i.e.*, the difference between settlement and contract prices.

CHAPTER NINETEEN

Business Intermediaries and Risk-Bearers

The specialisation of marketing functions has brought into existence a number of business intermediaries whose functions it is to direct the flow of goods on their way from producer to consumer.

These business intermediaries or *middlemen*, as they are called, have established themselves profitably at various points in the marketing process. The wholesaler and the retailer are middlemen and there are others who operate between wholesalers and retailers and between manufacturers and wholesalers. These are known as *agents, factors, brokers, dealers, merchants or speculators*, and *their primary function is to help to bridge the gap between buyers and sellers.*

The need for the services of the middleman is often questioned. To some he performs no useful function and takes advantage of every opportunity to raise prices to the consumer. This is not a true estimate of the position. The middleman serves a useful purpose; he is the signpost which directs the goods to market, an expert specialising in marketing, and thus he relieves manufacturers of tasks outside their scope. The manufacturer's business is to produce and *the link between producer and consumer is the middleman* who finds a market for the producer, discovers what the consumer wants and satisfies those wants. With his expert knowledge of demand and supply the middleman is able to direct goods from regions where they are plentiful to regions where they are scarce.

ELIMINATING THE MIDDLEMAN

In many branches of trade and industry the middleman has been cut out as a separate entity and produce is marketed by the most direct route. Not only in the home trade is he being dispensed with; direct dealings between manufacturers and foreign buyers are also increasing. The appointment of consuls and trade commissioners in commercial centres, the facilities provided by the telegraph, telephone, postage (especially air-mail) and international exhibitions, enable manufacturers to keep in touch with buyers, to supply direct and so eliminate the middleman.

In the case of perishable goods, direct marketing from producer to consumer especially on a co-operative basis has the advantage that considerable time may be saved and expensive storage facilities eliminated, while, in the case of specialty goods, marketing by the produ-

cer's own representatives may be more efficient than marketing by a general merchant. Finally, there is the general effect that there must be a direct saving on financing, on records and on bookkeeping when fewer changes of title take place and goods are transferred from the actual producer or wholesaler direct to the retailer or even to the consumer.

Various methods have been employed to dispense with the middleman, among the most important being the following:

- (1) **CARTEL ORGANISATION** with selling agencies. Here producers themselves combine to sell their products.
- (2) **VERTICAL COMBINATION** to secure raw material supplies and/or markets for the finished products. Thus Unilever has its own supplies of vegetable oils, and iron mining concerns and steel and engineering firms combine together to secure both raw materials and markets.
- (3) **DIRECT BUYING** of raw materials by manufacturers from raw material producers. This is more common than—
- (4) **DIRECT SELLING** by manufacturers either by the mail-order system or by the opening of retail stores, as in the boot and shoe trade.
- (5) **CONSUMERS' CO-OPERATIVE SOCIETIES**. Here consumers combine to buy direct from wholesalers and manufacturers, and in some cases may even acquire their own sources of supply.
- (6) **FARMERS' CO-OPERATIVES** to sell market-garden produce direct to retailers.
- (7) **RETAILERS' CO-OPERATIVE BUYING ASSOCIATIONS** to buy direct from manufacturers.

Quite apart from the positive measures taken to eliminate the middleman, there has been a material decline in the number of independent wholesalers as a result of the decreasing importance of small shops and the increasing numbers of chain stores and supermarkets which find it economical to deal direct with manufacturers and other producers.

Much of the criticism of the middleman is based on the argument that it is possible to dispense with his services. Economically, it may be possible to dispense with a middleman, but his functions remain and must still be performed by someone. Manufacturers who sell direct to the public through their own shops are combining the functions of production with those of marketing, and much of their success must depend on the manner in which they discharge the latter function. Indeed, the problem of the middleman would appear to be whether the functions of marketing are best performed by a specialist or whether they could better be merged with another function.

TYPES OF INTERMEDIARIES

BROKERS

In the marketing of many commodities the services of a *broker* are employed. A true broker merely negotiates for the sale or purchase of goods and neither handles them nor performs any of the ancillary services which are discharged by the commission salesman or commission buyer. In practice, however, many so-called brokers actually handle the produce which they buy or sell.

Amongst *produce brokers*, *i.e.*, those who arrange for the purchase and sale of raw materials and commodities, specialisation is carried to a very high degree. This is particularly the case in the important markets for imported goods such as rubber. Many commodities, *e.g.*, wool, are sold by auction, but large quantities of these commodities, as also the whole of those commodities which are not imported in sufficient quantities to justify sales by auction, are disposed of by private sales through the medium of brokers who are in constant touch with buyers.

The usual procedure is for the grower to sell his crop to a shipper who notifies his broker that he has a consignment for sale and mentions a price. The broker then negotiates for the sale of the commodity and obtains offers which he submits to the shipper. After some bargaining the broker will probably complete a contract for his principal and arrange for delivery of the consignment to the purchaser.

Clearly, the services of the broker are of great benefit both to sellers and to buyers. Besides bringing into relationship buyers and sellers who otherwise might never hear of one other, a broker often actually arranges to have the goods put in a suitable condition for delivery. Brokers maintain extensive organisations for keeping in touch with suppliers and with customers, and their advice is frequently invaluable to the producer who is not himself able to study market movements and other problems of importance to his business. Moreover, as each broker acts for several firms, he is able to secure fair prices for producers; he is in touch with most of the buyers in the market and is, therefore, in a much better bargaining position than the grower or the shipper. The charges made by the broker for his services are comparatively small and are certainly lower than would be the cost to the producer of marketing his own produce.

COMMISSION AGENTS

This title represents the genus of which commission buyers and commission salesmen are species. Commission agents exist in every

branch of trade and, generally, they have the authority and liabilities of a *factor*, being liable on contracts into which they enter. For instance, a commission agent who acts on behalf of a foreign importer or exporter is liable (in the absence of agreement to the contrary) to the person with whom he contracts just as much as if he were contracting on his own behalf. Moreover, when a commission agent contracts in his own name, without disclosing either the fact that he is an agent or the name of his principal, he becomes personally liable on the contract; he is then sometimes known as a *commission merchant*.

'DEL CREDERE' AGENTS

An agent of any kind who arranges with his principal that he will hold himself *personally liable* for the default of the customers he introduces is known as a *del credere* agent, and he is paid an extra commission, known as *del credere commission*, for undertaking this risk in addition to carrying out the normal business of an agent.

RELATIONSHIP OF INTERMEDIARIES

The relationship of some important types of business intermediaries, both to one another and to the business in which they function, may be usefully indicated by a brief consideration of the organisation of the fresh fruit and vegetable market as it is centralised in London. In this connection it may be observed that the place of production is an important factor to be considered in deciding how the marketing of produce shall be carried out. For instance, fresh fruit and vegetables are usually grown in places which are some distance from the consumer; those growers who are situated near an area of dense population may be able to dispense with the services of an intermediary and sell direct to the consumer or to the retailer, but other growers, less conveniently situated, find it best to market their produce through a wholesaler, whilst others again—and these are an important group—market their produce through *commission salesmen*.

The commission salesmen facilitate the marketing of produce *in bulk*. They operate in the whole markets and sell direct to wholesalers and retailers or to intermediaries in other markets and towns. In the case of fruit and vegetables, their business is facilitated by the wholesale fruit and vegetable market places which exist in most important towns, and which function as collecting, distributing and grading centres.

The business of the commission salesmen is to sell their clients' produce at the best possible price. They are in constant touch with market affairs and are in a position to advise growers when and what

to sell. The commission salesman is not merely a selling agent, however, for, besides finding customers for his principals, he may also provide baskets or crates for packing and may pay various charges, including freight, which are incurred in marketing the goods. He carries out all sales in his own name and accounts to the grower for the proceeds, at the same time accepting responsibility for the solvency and good faith of his purchasers and thus bearing the risk of bad debts. For his remuneration the commission salesman deducts from the proceeds of his sales his agreed commissions and expenses.

The *commission buyer* performs functions for the buyer similar to those which the commission salesman performs for the producer. In some instances, the commission buyer makes his purchases direct from the grower. He also performs many of the services carried out by the commission salesman, such as paying expenses, arranging for carriage and delivery, and dividing produce into convenient lots. In consideration for his work he receives an agreed commission.

It is now possible to consider the process of marketing fresh fruit and vegetables in and around London. The grower makes use of the services of the London commission salesman who sells to the London wholesale merchant; the latter sells the produce to the provincial commission buyer who purchases the goods on behalf of the provincial wholesale distributor. The produce passes from the latter to the retailer by whom it is finally marketed to the public. It is not surprising, therefore, that the difference between the price obtained by the grower and that paid by the consumer is high; for besides the profits which each of these intermediaries expects, there have also to be paid the heavy portorage and freight expenses necessitated by the frequent handing and transportation of the goods. On the other hand, it must be remembered that, had the growers to attend to all the details of marketing and to bear all the expenses incurred and trouble involved, the ultimate price to the consumer might be even higher.

Anyone who undertakes the management and direction of a business of necessity assumes certain risks, and his skill or lack of skill in evading these risks is indicated by the balance on his profit and loss account. The actual nature and extent of the risks necessarily vary according to the type of business; some businesses are by their nature more *speculative* than others.

SPECULATION

Speculation is a term of varied interpretation and of wide significance: in fact, anyone who produces in anticipation of demand may be said to be a speculator, but the primary application of the term is to that class of business operation which is undertaken in the expectation of

making a profit from price movements. *The fundamental principle involved is the purchase or sale of a commodity now with the object of a sale or purchase at a profit at some future time.*

Speculation is of two distinct types:

1. SPECULATION PROPER, *e.g.*, the operations of a dealer in produce, who speculates on the probability of a rise or fall in the price of a commodity. If, for example, rubber crop prospects are good, a dealer may sell for future delivery a quantity of rubber he does not actually possess, in the anticipation of a future fall in prices; if prospects are poor, he buys in anticipation of a future scarcity and high prices.

2. ILLEGITIMATE SPECULATION, or gambling, consisting mainly of operations undertaken blindly and ignorantly by uninformed speculators with the idea of reaping large profits. It may also signify *deliberate* manipulation of the market. The risk of loss is considerable, and frequently the whole of the capital invested may disappear. Speculation of this kind is harmful to the community in general, for private investors are frequently victimised by the violent price fluctuations so engineered. While legitimate speculation tends to smooth out fluctuations in prices, gambling serves only to accentuate them.

“Bulling” (*i.e.*, buying for a rise) and “Bearing” (*i.e.*, selling for a fall) are perfectly legitimate when undertaken in anticipation of a *natural* movement in prices, but not when undertaken with the object of producing an *artificial* level of prices.

Such highly organised markets as the stock exchange and the produce markets are particularly suited for such operations, for in them there is that element of uncertainty, both as to the supply of and the demand for the commodity, that gives operators an opportunity of making speculative profits, and enables them, by bringing into play powers of foresight and anticipation, to earn a reward for their business ability in estimating the tendency of prices.

Speculation smooths out the flow of produce and enables supply and demand to be kept more or less steady without violent price changes. It tends to increase the supply of things when they are likely to be most wanted and to check supply when demand is least urgent and it is therefore of great service in aiding the adjustment of supply and demand by discounting in advance the effect of any otherwise awkward and disturbing change.

It is sometimes said that speculation invariably increases fluctuations in prices. While it is true that in a highly organised market every item of news, good or bad, will affect prices and therefore make changes more frequent, the effect of speculation is to reduce the *amplitude* of these fluctuations and to spread the changes over longer per-

iods. Short-term changes cannot, of course, be avoided, for these are inevitable features of an organised market.

On the other hand, speculation can be attended by certain undesirable effects. Since speculators make their profits out of price changes it is obvious that there are times when it pays them to manipulate prices themselves. Such manipulation may be effected either by direct dealing or by indirectly influencing other persons.

An outstanding form of market manipulation is the "corner", whereby the *bull* operator endeavours to force prices up. A "corner" really involves the acquisition of control of the whole supply, but this is nowadays almost impossible in respect of any of the common commodities, and the term is used to mean control of the supply of a commodity available at any particular date. A successful corner is extremely difficult to arrange, for the rise in prices which follows heavy buying tends to attract supplies that would normally be marketed later. As a general rule, therefore, a corner will be successful only if the views of the operator are more correct than those of the market as a whole.

ARBITRAGE OPERATIONS

An operator in this type of business takes his profits from *known* price differences existing in different places *at the same time*. He must be distinguished from the more common type of speculator proper whose profits (or losses) are derived from *anticipated* price movements *over a period of time*.

Usually it is necessary for arbitrage operators, or *arbitrageurs*, as they are called, to operate in conjunction with agents or market operators in foreign centres. They keep in close touch with one another, and at frequent intervals remit information concerning ruling prices of either goods, securities or foreign exchange—according to what happens to be their specialty; it is necessary, then, for each to convert the prices quoted in foreign currency into terms of his own currency. The method of dealing is based on the simple principles of buying where prices are lowest, and selling where they are highest.

It is obvious that any price difference that may exist between two centres foreign to each other is composed partly of a difference in commodity prices and partly of a difference in foreign exchange rates. Still more obvious is it that the possibility of profit in arbitrage dealings will be greater when prices fluctuate than when they are stable; but under those conditions, deals must be carried out with great rapidity (*i.e.*, by cable or telephone), otherwise an unfavourable fluctuation may turn a profit into a loss.

THE ELIMINATION OF RISK

Although some element of risk or of speculation is associated with every class of business, means do exist whereby the trader can protect himself against the various risks to which his business is subject. Of these, the most important and obvious method is *insurance*. This is dealt with comprehensively in later chapters, but here it may be observed that the risk of loss through fire or burglary may be transferred to insurance companies. The risk of breach of contract may also, in some cases, be insured against. The system of hire purchase and of instalment selling introduced a new form of credit risk, but even in this sphere there has arisen a type of business house which finances consumer credit and is willing to take part of the risks.

The risks of bad debts, again, are inseparable from any business which grants credit to its customers, but these also may be largely avoided if effective use is made of the services of *Credit Inquiry Agencies*, which not only supply information concerning the financial position of various traders, but also undertake the recovery of debts. Even greater security against losses by bad debts may be obtained by means of insurance with a *credit insurance* company, the effect of which is to change the risk of bad debts, unpredictable in total, for a regular cost in the form of a premium. The most common type of credit insurance is the *whole turnover policy*, where the trader insures all his customers' accounts, the premium rate being determined by the insurance company after considering the nature of the trader's business, the standing of his more important customers, the length of credit he allows and his past bad debts experience. Alternatively the trader may insure selected classes of business or even specific accounts but as there is then selection against the insurance company the rates will be higher. In the export trade the Exports Credits Guarantee Department of the Department of Trade provides similar facilities (see page 404).

In both home and foreign trade, traders can also cover the credit risk by contracting with a *credit factoring company*. These companies are usually financed by merchant bankers, so that they have large resources and an extensive credit information service. The company undertakes to pay the amounts of all invoices in full on their due dates, less a commission, if the trader refers to it for credit approval all inquiries from new customers and all orders, and when invoicing requires payment to be made to it. The trader is thus relieved of the credit risk, of all sales accounting and debt collecting work, and can concentrate on expanding his sales.

SPECULATION AND RISK-BEARING

Whilst it is true that speculation and risk-taking are so identified that the terms are used interchangeably, it must not be imagined that legitimate speculation *creates* risks—really the essential features of gambling. On the contrary, it transfers existing risks to the shoulders most capable of bearing them. The business of producing goods in advance of demand, from the very nature of the circumstances, inevitably involves heavy risks, which must be borne by someone. The system of market speculation enables a trader to transfer the price risk to a specialist market dealer.

Because of his capacity for making trade forecasts from trade reports and other economic signs, the successful market speculator is able to undertake apparently enormous risks and deal with them efficiently.

FUTURES

The rise of market speculators has resulted in the development of the "futures" system. Besides being bought and sold for immediate delivery, goods are dealt in for delivery in the future, in which case no money is paid and no goods are delivered *until the date for the completion of the contract*. The fact that a dealer has undertaken to deliver in the future a certain quantity of a commodity at a certain price does not mean that he has the goods *in his possession*; indeed, as a rule he has not the goods and, what is more, he has no intention of ever handling them. He merely attempts to forecast the future trend of prices, and undertakes delivery on terms which his forecast suggests will be advantageous. In other words, he guarantees to the buyer to provide him with a given quantity of a commodity in the future *at a certain price* and thus relieves him of the risks of market fluctuations. The advantages to the buyer are obvious. If he is a manufacturer he knows immediately how much his future supplies of raw material will cost him, and, as he can estimate his other costs with comparative ease, he is able to fix at once his selling prices and enter into long-term contracts with greater safety. In effect however settlement is usually made by the payment of differences between the price agreed in the futures contract and the spot price at the date of maturity.

The dealer or speculator who has sold or bought for future delivery rarely undertakes the whole risk himself, for this would amount to basing all his dealings upon a single forecast. He has to make allowance for many factors which cannot be exactly assessed, and he attempts to cover himself as far as possible against miscalculation. Dealings take place between market operators themselves and, by this means, risks are transferred from dealer to dealer until they are

fairly evenly spread over the whole market. Having effected a contract in futures, a dealer will usually lessen his risks by entering into a fresh contract with another dealer for part of the original contract. In all probability the second dealer will pass on some of the risk which he has assumed and so on. In this way the losses and profits of speculation are spread over the market.

HEDGING

Speculation in the great organised produce markets has made possible the development of a special form of risk transference known as *hedging*.

As an example we consider the case of a Canadian flour manufacturer, who buys grain at the current price as raw material for his mill. If the price of grain falls before his flour is marketed he may have to sell the flour at a reduced price, since the price of flour usually falls in sympathy with the price of grain. In order to cover this risk, therefore, the flour manufacturer "hedges" his purchase of *spot* grain (*i.e.*, grain for immediate delivery) by making another contract to sell grain *in the future*; in other words he effects a *forward* sale. If, as he feared, the price of grain falls before his flour is ready for the market, he will lose on *his product*, because he will have paid more than subsequent prices warrant, but he makes a profit on his *future contract*, for when the time comes for completion of the contract by delivery he is able to buy spot grain at a price lower than that which he receives for his forward sale. Thus he is able to set off the gain on his future contract against the loss on his flour transaction.

The effect of a "hedge" is to ensure to the trader his normal trading profit and to eliminate any speculative profit or loss due to price changes. Hedging is commonly resorted to in circumstances such as the following:

- (1) An importer who buys goods to arrive, say, two months after the date of purchase, hedges by *selling a future* in such goods for delivery in two months; *i.e.*, he protects himself against a fall in the price of such goods. If, when he comes to sell his goods, the price has fallen, he makes a loss; but this is offset by the profit on his futures transaction.
- (2) A manufacturer who has orders for future delivery hedges by *buying a future in the raw material*, *i.e.*, he protects himself against a rise in the price of his raw material. If, when he comes to purchase his raw material for manufacture, the price has risen, he makes a loss on his manufacturing contract, but that loss is offset by this profit on the futures deal.
- (3) In some trades the price of the finished product and the price of

the raw material move in unison, *e.g.*, in the case of flour milling. In such a trade a manufacturer who is making for stock can hedge by *selling a future in his raw material*. If, when he markets the finished product, prices have fallen, he loses on his manufacturing transactions, but this loss is offset by the profit on his futures deal.

Dealings in futures are usually restricted to one or two ideal grades of the commodity, and thus it is comparatively rare for actual delivery to take place. For example, in (2) above, a manufacturer may require, say, No 3 grade, whilst all future dealings are in No 1 grade. Clearly a delivery of No 1 grade would be useless to him, but as there are no dealings in the required grade, the manufacturer, if he is to hedge at all, must buy a future of No 1 grade. This is an important reason why the vast majority of future deals are settled by payment of "differences": the market in futures is really only a system of insurance against price changes. The customary practice is for the party who stands to lose on the contract to pay the *difference* between the agreed future price and the spot price ruling at the date for fulfilment of the contract. In the above illustration, therefore, it would not have been necessary for the miller to go to the trouble of buying "spot" grain wherewith to effect delivery on his forward sales; instead, he would have been paid the difference by the dealer with whom he made the forward contract. Had there been no movement in the price of "spot" grain the miller would have made his customary profit on his flour and no differences would have been paid or received on the future contract. Finally, if the price of "spot" grain had risen, the miller would have been obliged either to buy grain at the enhanced price to complete his "future" contract, or, more probably, to pay the difference to the market operator. What he lost on his future contract, however, he would recover out of the higher price at which he could sell his flour.

CHAPTER TWENTY

Insurance—1: Basic Principles and Marine Insurance

Insurance is an essential safeguard for the businessman against the risks of loss inherent in the workings of the market economy, in which production generally takes place in anticipation of demand. It was described by Lord Mansfield as “a contract on speculation”. Essentially it is based on a contract, a policy of insurance, between the insured or assured person and the persons who insure, who are known as the insurers. The insurers undertake, for a consideration (the premium), to reimburse the insured in the event of certain accidental occurrences during a stated period of time resulting in economic loss.

The word “insurance” at one time was synonymous with “assurance” but now a fine distinction is drawn between the two words. “Assurance” is applied to those contracts which guarantee the payment of a certain sum on the happening of a specified event which is bound to happen sooner or later, *e.g.*, death. Most life policies come under this heading. “Insurance” contemplates the granting of agreed compensatory payments or benefits on the happening of certain events stipulated in the contract, events which are not expected but which *may* happen. It is, therefore, a contract of indemnity against a contingency, such as is contained, for example, in a comprehensive motor-car policy granting protection, *inter alia*, against *possible* accidents and legal liability arising therefrom.

BASIC INSURANCE PRINCIPLES

GOOD FAITH

Insurance contracts, unlike most other contracts in which the parties are merely required to abstain from positive deceit, are characterised by the need for the utmost good faith (*uberrima fides*) by all parties throughout the contracting period, and the doctrine of *caveat emptor* (let the buyer beware) does *not* apply. “Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain from his ignorance of that fact and his believing the contrary”: Lord Mansfield.

The insured must not only tell the truth in all statements made by him to the insurers, but must also disclose *everything material* that is, or ought to be, known to him. A fact is material if it would influence

prudent insurers in accepting or declining the risk or in fixing the conditions of insurance or rate of premium.

The duty of good faith applies equally to the insurers, who are bound to place at the disposal of the proposer all material facts they possess concerning the risk.

Breach of good faith renders the contract voidable *ab initio* at the option of the aggrieved party. As a consequence the insurer may repudiate the insurance contract without return of premiums.

INSURABLE INTEREST

Insurance has often been regarded as a wager, and, indeed, the contract of insurance was at one time often used for gambling, *e.g.*, on the expectation of human life, or on the risk of loss by maritime perils. It might be difficult, in fact, to draw the line in insurance between a contract which is a legitimate transaction and one which is by way of gaming, but the acid test is what is known as *insurable interest*. An insurance contract effected for the benefit of a person who has no insurable interest in the subject-matter insured (or, in marine insurance, a *bona fide* expectation of acquiring such interest) is unenforceable at law.

Insurable interest exists only if the following conditions are fulfilled:

- (a) There must be some person, object or chose in action on which the insured peril can operate, or some potential liability which the insured peril may cause to come into force.
- (b) This person, object, or chose in action or potential liability must be the subject-matter of the insurance.
- (c) The insured must bear some relation thereto, recognised by law or in equity, in consequence of which he stands to benefit by the safety of the property or chose in action, or by the absence of liability, and be prejudiced by the loss of the property or chose in action, or the existence of liability.

The time at which insurable interest must exist varies according to the particular class of business, as follows:

- (a) FIRE AND ACCIDENT INSURANCES. Continuously from the time when the policy attaches until the time when the loss occurs.
- (b) LIFE. When the policy is taken out, but not necessarily when the claim is made.
- (c) MARINE. At the time of the loss only, provided that there was a *bona fide* expectation of acquiring an insurable interest when the policy was effected.

A person who takes an assignment of a life policy, however, need not, at any time, have any interest in the life assured apart from the consideration for which he took the assignment.

INDEMNITY

With the exceptions of life and personal accident business, all classes of insurance are based upon the principle of indemnity. If this principle did not apply, insurance would become a mere gamble upon the happening of an event, the occurrence of which would benefit the insured, and over-insurance would be the rule rather than the exception. Indemnity makes good the insured's actual loss up to the limit of the amount covered by the policy.

SUBROGATION AND ABANDONMENT

Subrogation is the right which one person has to stand in the place of another and avail himself of all the rights and remedies of that other.

To ensure the equitable operation of the principle of indemnity, subrogation precludes the insured from being indemnified from two sources in respect of the same loss. In cases of double or over-insurance, the insured is not permitted to obtain more than legitimate indemnity, neither is it permissible for him both to claim under a policy of insurance and also to retain any damages recovered from third parties.

Insurers are entitled at Common Law to be subrogated, to the extent of the loss paid, to all rights which exist against third parties in respect of the loss, and may require the insured to enforce such rights, in his own name, but at the insurers' expense. Fire and accident policies usually contain a condition, modifying the Common Law, to the effect that the insured may be required to institute the action *before* payment of the loss. If the amount recovered in such an action exceeds the amount payable by the insurers, the insured may be called upon to pay his proportion of the legal costs incurred. Marine policies, however, contains no such condition, and the loss must be paid before subrogation can be enforced. It is usual for insurers to require the assured to sign "letters of subrogation" agreeing to take proceedings, if required, on behalf of the insurers but in the name of the assured.

Subrogation does not apply to insurances other than contracts of indemnity and does not involve a transfer of ownership of the subject-matter to the insurers, If, however, the insured *abandons* the subject-matter and the insurers accept it—they are not bound to do so—they

become the owners, and, after settling the insured's claim for a total loss, they may repair and dispose of the subject-matter for as much as possible, irrespective of the amount of their payment to the insured.

CONTRIBUTION

The contribution clause is common to fire insurance and applies in some classes of accident insurance. (It is a statutory requirement in marine insurance.) It limits the amount claimable from individual insurers so that the amount payable by each insurer is governed, not by the sum insured by him, but by his rateable proportion of the loss. Were it not for this clause, an insured could recover from any individual insurer the full amounts of his loss (up to the sum insured by the policy), but the principle of contribution would apply, so that an insurer who had paid more than his fair proportion of a loss could enforce contribution afterwards from the other insurers.

When an insured recovers a sum greater than his prescribed indemnity, he holds the surplus in trust for the benefit of the insurers in proportion to their rights of contribution.

Contribution does not apply to life assurance or personal accident insurance, but it is observed in the marine branch, although here the contribution clause itself is unknown, and, where there is over-insurance or double insurance, the assured may claim on his insurers in whatever order he pleases, any insurer paying more than his due proportion being entitled to enforce contribution from his co-insurers.

ARBITRATION

Most fire and accident insurance policies contain a clause providing that differences arising under them as to the amount payable, liability having been admitted by the insurers, shall be referred to arbitration. Differences as to liability, or as to liability and amount, fall to be decided by court action.

UNINSURABLE RISKS

Insurance covers a very large number of risks attendant on business, but there are some types of risk that cannot be insured against. Risks of this nature include, for example, risks the direct result of which cannot be quantified, *e.g.*, those arising from a sudden change in fashion, those arising from price changes or an intensification of market competitive conditions.

TYPES OF INSURANCE

Four principal types of insurance are outlined below and in the following chapter:

- (a) Marine Insurance;
- (b) Fire Insurance;
- (c) Accident Insurance;
- (d) Life Assurance.

MARINE INSURANCE

The law relating to marine insurance was codified under the *Marine Insurance Act* 1906. Marine insurance is embodied in contracts whereby the insurer (known also as the "underwriter") undertakes to indemnify the insured on agreed terms against losses incidental to marine adventure, *e.g.*, as wherever ships are exposed to perils consequent on, or incidental to, navigation of the sea.

LLOYD'S

The objects of Lloyd's—the world's supreme marine insurance organisation—are the transaction of insurance business by the members, the advancement and protection of the members' interests, and the collection and publication of information of use to members and others. At Lloyd's are kept books which are posted to date with particulars as to sailings, positions, arrivals and casualties of all vessels, a special service having been organised all over the world for the communication of relevant information to headquarters. *Lloyd's Agents* are established at almost every port in the world, and their duties include the reporting of casualties to Lloyd's and the appointing of surveyors to inspect damage to ships and cargo.

All underwriting business at Lloyd's has to be transacted through the medium of a *broker*, who is the agent of the assured, although his brokerage is deducted from the premium received by the insurer. The Corporation itself neither issues policies nor assumes liability thereunder, all business being transacted by the individual members.

The general practice is for several members in association, but not in partnership, to carry on their business through an authorised *underwriting agent*, who acts for the whole group or syndicate. The actual "underwriting" is done when each underwriter's name is subscribed at the foot of the policy against the amount for which he accepts liability, and each member of the group is liable only for the amount which he has so underwritten.

MARINE INSURANCE COMPANIES

The association of Lloyd's is comprised of a group of private individuals, each of whom risks his own personal capital when he underwrites a policy. But in addition to these there are a number of joint-stock undertakings which either specialise in marine insurance, or carry it on in conjunction with other classes of insurance.

The marine insurance companies sometimes negotiate for business direct with the public, but the bulk of their operations is conducted through the medium of *agents* whom they appoint with general or limited powers to bind them on risks, and who are usually provided with a flexible schedule of rates of premiums and limits of sums insured applicable to the different classes of business transacted. The companies also have *claims settling agents* at the principal ports.

The marine insurance companies and Lloyd's work together in harmony; in fact, the former subscribe to the latter so that they may benefit from the great intelligence organisation of that institution.

FORMATION OF THE CONTRACT

The method adopted in effecting a contract of marine insurance differs from that employed in the other branches of the business, where, except perhaps in the case of fire insurance, a proposal form must be completed. Marine business is almost invariably placed through a broker, who, on receipt of instructions from his principal, makes out an abbreviated memorandum of the risk, which is termed an *original slip*.

The broker takes the original slip and "offers" it for subscription to an underwriter at Lloyd's or to a "company" underwriter. If the underwriter thinks the risk is acceptable, he quotes a rate per cent, and, if this is accepted, the underwriter "writes his line on the slip", *i.e.*, the amount he is prepared to underwrite, initials this figure, and dates it. Where large amounts are concerned, the broker will have to take the slip to several underwriters to secure subscriptions to the full value indicated.

In due course, an insurance contract as evidenced by an original slip must be finalised. The broker awaits receipt of closing instructions from the assured, for it may happen that these may not coincide exactly with the particulars contained in the original slip, *e.g.*, part of the consignment may have been "short-shipped". At one time, in the case of insurances placed with companies, it was the broker's duty to prepare on the instructions of his client a closing slip—known also as a "forward" or "definite" slip—on a form supplied by the company concerned. Nowadays, in the London market, although such closing slips are still in use, the majority of risks are expressed in

“combined companies’ policy forms” issued under the sanction of the Institute of London Underwriters.

A “closing slip” when used would set out at greater length than the original slip the details of the insurance, together with the name in which the policy was to be made out. Attached thereto would be copies of the clauses to be embodied in the policy. From these particulars the policy would be made out in the office of the company from the particulars given—of course, after checking these with the relative entry in the “risks book” in which details of insurances written are entered at the time of acceptance by the underwriter or his deputy. The broker would in due course collect the policy, which he is entitled to retain in his possession (brokers’ lien) until receipt by him of the premium from the assured.

In the case of policies to be presented for execution to a Policy Signing Office—Lloyd’s or Companies’—no closing slips are used; in these cases the broker has the policies prepared in his own office, presenting them together with the relevant original slips to the appropriate Signing Office for execution.

OPEN COVERS

The method described above is generally followed in respect of hull and freight insurances, but in the modern practice of cargo insurance the use of original slips in the insurance of individual cargo shipments has been almost entirely superseded by the system of *open covers*. Open covers are contracts binding the insurers—and for that matter the assured also—in honour only. They are current for a period of time, usually twelve months. In the first instance, an open cover is negotiated by means of an original slip. Under such an agreement the assured is in honour committed to declare and the insurers to accept declaration of all shipments falling within the terms of the cover. From time to time, individual policies will be issued covering the various declarations; or “floating policies” may be issued as required against which shipments will be declared until such policies are exhausted, when they will be replaced within the terms of the cover by others. In such circumstances, the assured will be issued with a book of certificates of insurance in approved form, in which certificates will be incorporated the terms and conditions applicable to the various insurances. Separate forms of certificate are used where claims are to be payable abroad.

In an open cover it is usual to incorporate a schedule of rates of premium applicable to particular goods and voyages, but shipments for which no rate has been specified are usually “held covered”, which implies that they will be accepted at rates “to be agreed”, *i.e.*, current market rates for the risks involved.

Contracts of this nature permit declarations to be made up to a fixed amount by any one steamer, "approved or held covered", regardless of previous declarations, but are usually subject to a cancellation clause, the period of notice being shorter for war and strikes risks than for marine perils. In open covers it is desirable to include a *basis of valuation clause* so that in the event of loss or arrival of a shipment before declaration no question can arise as to its insured value.

Sometimes, but not often, an open cover may be arranged for an agreed amount (say £100,000), which is automatically reduced as shipments go forward. Such "covers" are commonly called "open slips" and contain no cancellation clause except in respect of war and strikes risks.

Permanent Open Covers nowadays are rarely negotiated, but were at one time not uncommon. Under such an agreement, no time limit would apply, but a cancellation clause would necessarily be included.

THE POLICY OF MARINE INSURANCE

A policy of marine insurance is an essential document in all overseas trading transactions. Briefly, it covers the usual perils of the seas, and also other risks, *e.g.*, fire and "thieves". Losses, of which the *proximate* (*i.e.*, dominant or effective) cause is not a peril insured against, are not covered, and *some* of the perils which are not covered by the ordinary policy are specially mentioned in the *Marine Insurance Act* 1906, *e.g.*, ordinary wear and tear, petty theft and pilferage, loss proximately caused by rats and vermin, inherent vice or nature of the subject-matter insured.

The *Marine Insurance Act* 1906, provides that a policy on ship or goods is free of any claim arising from delay, even if the delay is proximately caused by a peril insured against, but this provision does not extend to freight (which does not include passage money). Therefore, the "time penalty Clause" has been introduced to protect underwriters from claims for loss of freight should a vessel, through delay, be unable to arrive at her destination at the date specified in her charter and thus, by the operation of a cancelling clause, lose her freight.

Marine insurance policies may be *valued* or *unvalued*. In the former class—which is almost universal—an agreed valuation is placed on the subject-matter of the insurance and is inserted in the policy. In the absence of fraud, such valuation is conclusive as between insurer and assured. In unvalued policies the value is not stated in the policy, but is subsequently ascertained in accordance with the provisions of the

Marine Insurance Act 1906. In addition to the agreed valuation or the value as subsequently ascertained, there is also, of course, a sum insured, which is the limit of underwriters' liability.

TYPES OF MARINE INSURANCE POLICIES

The principal types of marine insurance policies are as follows:

- (1) VOYAGE POLICIES, by which the subject-matter is insured for a specified voyage, *e.g.*, London to Rangoon.
- (2) TIME POLICIES, under which the insurance is effected for a specified period of time, not exceeding twelve months, *e.g.*, from noon, 17th July, 1978, to noon, 17th July, 1979. Policies of this nature are used chiefly in connection with the insurance of ships, though voyage policies are also sometimes used for this class of business.
- (3) CONSTRUCTION OR BUILDERS' RISKS POLICIES, which are issued usually for a period exceeding twelve months, to cover the risk of damage to vessels during the period of construction, during trials and until delivery to the owners.
- (4) PORT RISK POLICIES, which cover a vessel whilst in port for a stated period of time.
- (5) FLEET POLICIES, by which several vessels belonging to one owner are insured under the same policy.
- (6) COMPOSITE OR COMBINED POLICIES, which are subscribed by more than one insurance company on the one policy. (The liability of the various companies, however, is quite distinct.)
- (7) MIXED POLICIES, which cover the risk for both a specified voyage *and* for a period of time. (A voyage policy may be extended to cover a period of time not exceeding thirty days after arrival without becoming a mixed policy.)
- (8) FLOATING, OPEN OR DECLARATION POLICIES, which are generally used by merchants or shippers who regularly despatch or receive goods. Thus, an importer of coffee from Java might arrange a "floating" policy against which declarations would be made as advice of shipments was received from the exporter. Similarly, professional exporters specialising in, say, the Eastern market might make declarations in respect of individual shipments against a floating policy. They are also useful for short voyages, where the merchant's goods may be at risk without his knowledge.

Forms known as "declaration" forms are supplied to the assured on which to fill in particulars of each shipment. As declarations are made, the sum insured is reduced by the amount of each shipment. All shipments must, of course, be declared, though *bona fide* omissions do not invalidate the policy. Most

“open” policies contain a “sailing warranty” (*e.g.*, “Warranted sailing on or before . . .”), which can be extended from time to time to give the insurers the opportunity, should they desire, of cancelling the policy at the expiry of the warranty. Except in so far as they may be governed by a sailing warranty, open policies are not issued for a period of time: they expire when the sum insured has been exhausted by declaration, unless, of course, the insurers have meanwhile declined to extend the sailing warranty.

CERTIFICATES OF INSURANCE

Certificates of insurance giving details of the shipments are issued (usually to the exporter in book form) in connection with declarations under floating policies. When goods are exported, such certificates are frequently included with the unstamped shipping documents as evidence of insurance. But certificates cannot be enforced in themselves, although they can be sued upon in conjunction with the stamped floating policy. Banks are usually prepared to accept such certificates as evidence of insurance, provided that the floating policy is available for their inspection.

“HONOUR” POLICIES

The *Marine Insurance Act* 1906, provides that policies effected by persons who possess neither an insurable interest nor any *bona fide* expectation of acquiring one are void, but policies are daily written to cover insurable interests not easily definable and, being void at law, are treated most scrupulously by insurers. They are, therefore, termed “honour” policies, or “P.P.I.” (policy proof of interest) policies. Such policies are a commercial necessity and are issued in cases where the assured has a genuine interest of an indefinable character; they are issued in connection with “increased value” insurances on commodities such as grain, cotton and sugar, which often change hands several times during one voyage and the value of which fluctuates considerably. In such cases, a claimant is not required to prove his interest, production of the policy being sufficient.

FEATURES OF ALL POLICIES

Lloyd’s policies are issued on standard forms, *i.e.*, based on that in the First Schedule to the *Marine Insurance Act* 1906, and these may be adapted for marine insurances of any kind—hull, freight and goods. If the terms are not exactly suited to the particular business, new clauses can be written or stamped on the policy, or attached to it by

means of gummed slips. Most companies, however, use policies which are similar to Lloyd's marine policy, but differ in the wording and in certain other minor respects. Separate forms are used for hull and cargo insurances respectively, but contain no major differences. The underwriters named in a Lloyd's policy are liable for the proportions of a loss set against their names, as also are marine insurance companies that cover a risk on a "Combined Companies' Policy Form". A single company issuing a policy is, of course, alone liable.

Although the form of policy varies according to circumstances, the *Marine Insurance Act* 1906, as amended subsequently, requires only the names of the assured or his agent to be embodied in policies, and the subject-matter to be designated with reasonable certainty. (This permits of stamped open covers and stamped certificates of insurance being enforceable as valid policies.)

The vessel's name is inserted when requisite. The vessel may not be changed without the consent of the underwriter, but in practice it is usual to add after a vessel's name the phrase "and/or vessel" so that the assured may remain covered in case of change. Should the substitution of one vessel for another cause the risk to be materially altered, the underwriter may require an additional premium. When the happening of an event insured against necessitates transshipment to another vessel, this does not determine the risk if the phrase "and/or vessels" is inserted, but unless this is specially agreed the ordinary policy does not cover transshipment even when effected in the normal course of trade. To cover this contingency, it is usual expressly to include the risk of transshipment, customary transshipment being covered without extra premium, but other transshipment attracting such additional premium as may be arranged.

DEVIATION

Any departure by a vessel from the route prescribed, or, where no route is prescribed, from the ordinary trade route, is known as *deviation*.

Unless permitted or justified, deviation releases the underwriters from liability as from the time of deviation even if the accident occurs after the ship has returned to her normal route, but without prejudice to insurers' liability for losses occurring before the deviation took place.

Deviation may, however, be permitted by a *Deviation and/or Change of Voyage Clause* in the policy, while the *Marine Insurance Act* 1906, excuses deviation: (1) where caused by circumstances beyond the control of the master and his employer; or (2) where reasonably necessary in order to comply with an express or implied warranty; or

(3) where reasonably necessary for the safety of the ship or subject-matter insured; or (4) where made for the purpose of saving life, or aiding a ship in distress where human life may be in danger; or (5) where caused by the barratrous conduct of the master or crew, if barratry (*i.e.*, fraud or criminal negligence) be one of the perils insured against. Except as provided by the Deviation Clause, deviation to save property as such is not justifiable.

As distinct from deviation, a *change of voyage* occurs where, after the insurance attaches, the port of destination stipulated in the policy is altered. The underwriters' liability ceases as from the time the decision to change is shown (*e.g.*, by radio instructions from the owners to the master), and it is immaterial that the vessel does not immediately leave the course of the original voyage. However, there may be a clause in the policy covering such an eventuality at a premium to be arranged.

The policy does not in any case cover a *different voyage*, *i.e.*, where the insurance has not attached because the vessel sails from or to a different port from that contemplated by the policy.

ASSIGNMENT OF POLICIES

Marine insurance policies on goods must of necessity be freely assignable, since goods are frequently sold, sometimes several times over, whilst on the water, and the insurable interest therein consequently passes through several hands before reaching the party ultimately taking delivery. In fact, many of the persons having temporary interest in the subject-matter may have no intention of taking delivery, *e.g.*, operators in futures markets. Meanwhile loss may occur.

In the case of *cargo* policies, the general practice is to assign them by blank endorsement—*i.e.*, the assignor merely signs his name on the back, as in the case of a cheque.

Endorsements on *hull* policies are usually more specific, *e.g.*, "The interest herein is hereby transferred to (Signed) (Dated)", for in the case of sale of a vessel, the assured cannot assign his policy without obtaining from the insurers their written agreement to the change of ownership or management.

CLAIMS

Although the broker is directly responsible to the insurer for premiums, the insurer is directly liable to the assured for claims and returns of premiums. Consequently, it is to the insurer that the assured has to look for indemnity for any loss.

Marine losses fall into two broad classes, *viz*, *total loss* and *partial loss*.

A total loss may be either *actual (absolute)*, or *constructive*; while partial losses comprise what are known as *particular average* and *general average*.

AN ACTUAL TOTAL LOSS occurs when the subject-matter is wholly destroyed, or is so damaged as to cease to be a thing of the kind insured, or where the assured is irretrievably deprived of possession thereof. Sometimes a vessel leaves port and disappears completely. In such circumstances the only means of proving that the vessel has been lost by a peril insured against is by inference. The *Marine Insurance Act* 1906, however, provides that where the ship concerned is missing and, after the lapse of a reasonable time, no news of her has been received, an actual total loss may be presumed. This is commonly termed a "presumed total loss". When a vessel is considerably overdue, the Committee of Lloyd's will, at the request of an interested party, circularise Lloyd's Signal Stations and Agents for news of the ship. If nothing is heard of her during the week after the notices are issued, she will be posted at Lloyd's as missing, and total losses will then be presumed on all policies effected on the vessel. (Should the vessel arrive after settlement of claims, the subject-matter becomes the property of the insurers.)

A CONSTRUCTIVE TOTAL LOSS occurs where the subject-matter is justifiably abandoned because its total loss appears unavoidable, or where it is so damaged that it is commercially impracticable to restore it.

The term "AVERAGE" is used in a special sense in marine insurance. In fire insurance it means that, in the event of under-insurance, the insured is his own insurer in respect of the amount under-insured, but in marine insurance the term signifies partial loss or damage. Average is divided into two main classes, *particular average* and *general average*.

"PARTICULAR AVERAGE" means partial loss or damage accidentally caused to the vessel or to a particular parcel of goods by perils insured against, *e.g.*, damage by sea-water, stranding, collision or fire, not amounting to total loss. Particular average must be borne by the owners of the property suffering the loss, and is thus distinct from "GENERAL AVERAGE", which is distributed over the whole ship, freight and cargo.

Partial loss of goods may be total loss of part of the insured goods, and, if so, the insurer under an unvalued policy must pay up to the insurable value of the part lost, and under a valued policy must pay

that proportion of the sum fixed by the policy which the insurable value of the part lost bears to the insurable value of the whole of the property covered by the policy.

If part or the whole of the goods arrives at destination damaged by a peril insured against, an entirely different method is adopted. The gross value which the goods would have had if sound on arrival is compared with the gross value on arrival in damaged condition. "Gross value", according to the *Marine Insurance Act* 1906, is "the wholesale price, or, if there be no such price, the estimated value, with, in either case, freight, landing charges, and duty paid beforehand; provided that, in the case of goods of merchandise customarily sold in bond, the bonded price is deemed to be the gross value". Gross proceeds (*i.e.*, of the damaged goods) means "the actual price obtained at a sale where all charges on sale are paid by the sellers". Under a valued policy the percentage of depreciation thus ascertained is applied to the insured value, whilst under an unvalued policy it is applied to the insurable value, and the loss thus ascertained is the measure of indemnity. By adjusting on the basis of *gross* values, the underwriters' liability is constant, irrespective of the state of the market. If *net* values were used in the adjustment of particular average claims, underwriters' liability would be affected by market fluctuations, and this does not fall within the scope of a marine insurance policy. Moreover, the percentage of depreciation would be significantly increased.

"GENERAL AVERAGE" means any extraordinary loss, damage or expenditure reasonably and *voluntarily* incurred for the purpose of preserving all the interests (ship, cargo and freight) imperilled in the common adventure, *e.g.*, cargo jettisoned to lighten the ship in order to refloat her after stranding; damage to cargo by water used for extinguishing a fire; the cost of towing a disabled vessel to port; damage to a ship's machinery, when worked excessively in order to float a stranded vessel. Such loss, damage or expenditure must be borne proportionately by all those interested, *i.e.*, the contributing interests.

General average exists quite apart from marine insurance but a merchant or shipowner usually insures against it. If he does so he can recover from the insurer any general average damage that occurs to his goods or vessel and leave the insurer to recover from the other interested parties a proportionate part of the loss. Similarly, he is insured against his liability for a general average contribution to make good general average damage sustained by other interests.

THE YORK-ANTWERP RULES

The law obtaining at the place where the adventure ends determines the adjustment of general average, subject to any provision to the contrary incorporated into the contract of affreightment. Inconvenience resulting from the conflicting laws of the various maritime countries on the subject of general average led to a desire for stability, hence the voluntary adoption of a code of rules.

The current code is the *York-Antwerp Rules*, drawn up in 1864 and last revised in 1974. This code is invariably incorporated in contracts of affreightment, but although binding as between shipper and shipowner, it has no effect on the contract of marine insurance. Hence the incorporation in the policy of the *general average clause*, by which underwriters agree to accept an adjustment in accordance with foreign law and practice, or in accordance with the York-Antwerp Rules if so provided in the contract of affreightment.

AVERAGE ADJUSTMENT

The statement of claim (or adjustment) may be prepared by the broker or by the assured himself. When insurances are placed with companies, the documents are frequently sent by the assured to the company, which may then make the necessary adjustment. Very often an average adjuster (or average stater) is employed to prepare the statement for presentation to the insurers. Moreover, when a complicated claim is presented to a company without a statement of claim, the company will often send the papers to an average adjuster for adjustment.

An average adjuster is not an employee or representative of either the insurer or the assured. He is an independent umpire whose duty it is to state the claim impartially and accurately according to the liability of the insurer under the terms of the policy.

Average adjusters are also employed to make up adjustments of general average on behalf of the interested parties.

LETTERS OF SUBROGATION

These are documents executed over a contract stamp which underwriters usually require when settling a total loss, or when settling a claim for partial loss in cases in which part of the goods remains to be realised, or when the assured may have some right of recovery against a third party.

The objects of subrogation letters are:

- (a) To transfer the assured's right arising out of the loss to

underwriters and, in the case of a total loss, to transfer to the latter the assured's title in the subject-matter of the insurance.

- (b) To give formal authority to underwriters to sue in the name of the assured for recovery against third parties.
- (c) To emphasise to the assured his responsibilities to the underwriters.

PROTECTION AND INDEMNITY ASSOCIATIONS

Cover against certain risks of loss which are not included in a marine insurance policy in its ordinary form may be obtained by utilising "Mutual Clubs" or "Protection and Indemnity (P. and I.) Associations", which give protection on a mutual basis against losses of this type, *e.g.*, claims for loss of life or personal injury; damage caused to wharves, piers, etc., for which the shipowner may be held liable; claims upon the shipowner for non-delivery.

CHAPTER TWENTY-ONE

Insurance—II: Fire, Accident Insurance and Life Assurance

FIRE INSURANCE

Whilst the business of fire insurance is of more recent growth than that of marine insurance (outlined in the previous chapter), the theory upon which it is based, *i.e.*, the distribution of the losses of the few over the whole insuring community, was put into practice many centuries ago. But it was not until The Fire Office (also known as The Insurance Office) was established in 1681, shortly after the Great Fire of London, that the business of fire insurance so called was systematically transacted. This was followed by the formation of numerous other fire insurance offices.

THE ORDINARY POLICY

Under a fire insurance policy the insurer undertakes, on payment of the premium, and subject to the conditions of the contract, to pay or make good to the insured any loss or damage by fire which may happen to the property insured during the period covered by the policy, up to the amount of the sum specified against the particular items in the policy. "Fire" means "*actual ignition*", and only loss or damage resulting from such ignition is covered. If an actual fire or burning is the proximate cause of the loss, and the fire is *accidental* or *fortuitous* in its origin so far as the insured is concerned, then such loss is covered by the policy. If, for example, an insured's property is damaged by smoke and by water used in extinguishment, as a result of fire in neighbouring premises, his loss is covered under his fire policy. The standard policy also includes damage due to lightning or due to the explosion of domestic boilers or of gas used for domestic purposes or for lighting or heating. It excludes, however, from the ordinary cover certain *perils*, the nature of which would affect the premium to be charged; for instance, fire occasioned by earthquake, riot or military power. It also does not cover certain specified *articles*, unless they are specially mentioned as insured, *e.g.*, goods held in trust or on commission, business books, plans, stamps.

The rate of premium varies, of course, according to the degree of hazard involved. Where more than one rate would apply to a risk—*e.g.*, a warehouse—owing to the varying nature of the tenancies, the figure to be charged is that which will produce the highest *net* premium.

AVERAGE

Under an ordinary fire policy, *without* the average clause, the insured can claim, in the event of a loss, up to the full amount of his policy, although he may be under-insured—*e.g.*, if the value of property is, hypothetically, £1,000, but it is insured for only £600, and a loss of £500 is sustained, the whole of this amount will be paid by the insurers, *viz.* £500.

If, however, the above policy is “subject to average”, then the insurers pay only $\frac{600}{1000}$ ths of the loss—*i.e.*, £300. Thus the effect of the Average Clause is to render the insured liable for such proportion of the loss as the value of the uncovered property bears to the value of the whole property.

FLOATING POLICIES, largely used for mercantile risks and covering fluctuating stocks held, for instance, in several warehouses, contain also a second condition of average, the object of which is to relieve the floating policy from liability to contribute to a loss which is also covered under a policy of more specific range—*e.g.*, one insuring the contents of one warehouse only—unless this latter insurance is insufficient to pay the whole loss, in which case the floater applies to the balance of the loss, subject to average.

SPECIAL POLICIES

For the convenience of merchants, several special types of policy have been evolved.

“EXCESS” FIRE POLICIES are issued by Lloyd’s and by some of the non-tariff offices. Such policies meet the requirements of traders whose stock on hand is liable to vary in quantity and in value from time to time. The perils insured against are the same as those covered by the ordinary fire policy, but insurance need not be maintained for the maximum amount of stock that may be at risk at any time. The “excess” policy is designed to cover fluctuations in value at an average cost, the *normal* amount at risk being covered by an *ordinary* fire policy on a specific sum insured. For example, it may happen that the normal value of stock in a certain warehouse is, say, £20,000. At any time, however, the value of the stock may increase to £30,000. An ordinary policy is effected for £20,000 and an “excess” policy is taken out for a further £10,000, and maximum cover for £30,000 is maintained. In respect of the “excess” insurance, declarations of the amount at risk are made periodically—*e.g.*, monthly—and from these declarations is ascertained the average amount at risk and the average premium payable.

The difficulty with “excess” policies is that the holder of such a

policy, who has also a standard policy covering the main risk, may be penalised by the operation of the condition in the standard policy which limits the standard policy's contributions to a rateable proportion only of the loss. Consequently "excess" policies have been practically eliminated by *declaration* policies.

DECLARATION FIRE POLICIES are similar to "excess" policies but are effected for a sum estimated to cover the *maximum amount which may be at risk at any time* during the term of the policy, the premium being determined by periodical declarations as described above. A percentage of the premium only is payable at the outset. These policies are issued by most offices and by Lloyd's.

"ADJUSTABLE" FIRE POLICIES are similar to "declaration" policies but whereas under the latter scheme, the insured declares the value of the stock at the end of an agreed period (*e.g.*, week or month), under an "adjustable" policy, the policy-holder notifies the company of his requirements on each occasion that the value of the stock insured undergoes appreciable increase or decrease, *i.e.*, *before* the risk is run. Naturally, this type of policy is not in such demand as the declaration type.

VALUED POLICIES. The peculiar conditions attaching to marine insurance do not apply to the insurance of goods on land, hence valued policies are the *exception* in fire and other branches of insurance. The value declared in the policy is the amount the insurer will have to pay the insured in the event of a total loss, and the insurers agree to pay this amount, irrespective of the actual value at the time of the loss. Such policies may be useful in insuring works of art and similar property, but may well operate to the disadvantage of one or other of the parties to the contract if the agreed value in the event of a claim proves to be either excessive or inadequate. The insurers still have the option, as under non-valued policies, of replacing the property instead of making a cash payment. Partial losses are settled according to the actual amount of loss sustained.

ASSIGNMENT

Fire and accident insurance policies are not assignable without the consent of the insurers, the only exception to this rule being where the insured's interest ceases by will or operation of law. The insured may, however, assign the *proceeds* of such policies.

CLAIMS

Immediate notification of a fire loss is essential so that the insurers may take prompt steps to safeguard their interests—*e.g.*, in dealing with

the salvage. Where the loss exceeds a certain amount (say, £1,000), insurers appoint an *adjuster to act for them in verifying the cause and extent of the damage*.

LOSS OF PROFITS OR CONSEQUENTIAL LOSS INSURANCE

An offshoot of fire insurance which is of great importance to the business community is that known as Loss or Profits (or Consequential Loss) Insurance, which, in its modern form, may be said to be a product of the present century. Briefly, this type of insurance is designed to indemnify the insured for the loss of profits which he sustains following an interruption of his business as a result of fire; its utility is, therefore, obvious. The usual policy covers (a) loss of net profit; (b) payment of standing charges—*e.g.*, interest on debentures and mortgages, directors' fees, rent, rates, salaries to permanent staff and wages to skilled officials, advertising (these charges must be borne by the insured even through business is at a standstill); and (c) increase in cost of working—*e.g.*, hire of temporary premises, orders completed by other firms at extra cost, extra advertising.

ACCIDENT INSURANCE

The term "accident insurance" originally had particular reference to what is known as personal accident insurance, the importance of which class of protection has been emphasised in recent years.

So universal, in fact, is the demand for accident insurance in its various forms, that it would be hard to find a householder who did not possess an accident policy of one kind or another, or a business that had not effected some kind of accident insurance.

THIRD PARTY LIABILITY

The liability to a third party arises in connection with most forms of accident insurance and denotes the liability of the insured to compensate any person who suffers loss through his negligence or that of his servants or agents in the course of their duties, *i.e.*, failure to exercise reasonable care to avoid injuring third parties or damaging their property.

TYPES OF POLICY

The more important types of accident insurance policies in use are:

MOTOR. Four main classes of policy are available, namely: (1) for

private vehicles, (2) for commercial vehicles, (3) for motor traders' vehicles, and (4) for motor cycles. The insurance covers, *inter alia*, loss of or damage to the vehicle or cycle by impact, fire or theft, and includes third-party liability. Such items as wear and tear, and mechanical breakdown, are excluded from the cover granted.

GENERAL THIRD-PARTY RISKS. Policies are available to cover the special risks of property owners; shopkeepers; theatre, cinema and hotel proprietors; educational authorities; builders and contractors; and professional men, such as doctors, dentists and accountants. Liability may arise following injuries to members of the public as a result of defects in premises, negligence of employees, lack of professional skill, and such liability may be covered by means of these policies.

Legal costs incurred in contesting claims relating to the liabilities arising under any of the foregoing types of policy are also covered.

BURGLARY. Policies are issued covering the contents of private dwelling-houses against burglary and theft. The contents of business premises are usually covered only against burglary, as theft by customers and employees is often too great a risk to be assessed. Other forms of insurance issued by the burglary department of an insurance company comprise "all risks" insurances on jewellery, furs, etc.; "baggage" insurance on luggage in transit; insurances on cash and securities in transit; and "cash-in-safe" insurances.

FIDELITY. Briefly, the main object of this form of insurance is to protect employers against financial loss by fraud or theft on the part of specified employees whose duties involve the handling of cash.

PERSONAL ACCIDENT AND SICKNESS. There are four types of policy, covering (1) personal accidents only; (2) personal accidents and certain specified diseases; (3) personal accidents and all forms of sickness; and (4) accidents and illnesses for a specific term of years—say, until the assured attains the age of sixty. The last type of policy is known as a *permanent health contract*. Certain risks are excluded from the cover granted—for example, intentional self-injury or suicide.

ENGINEERING. Policies are issued covering boilers against explosion; steam, gas and oil engines against mechanical breakdown; electrical machinery against electrical and mechanical breakdown; and lifts, hoists and cranes against mechanical breakdown. The insurance may also provide for third-party liability, and law costs.

BAD DEBTS INSURANCE. The business of bad debts insurance is fast developing.

Unlike many other classes of insurance business, in bad debts in-

insurance the insurer does not bear the entire risk, the custom being for the insured himself to bear at least 10 per cent of the loss.

The following are the chief types of policies issued:

- (a) *Bills of Exchange Policies*. These cover loss in respect of bills of exchange (drawn by the insured and accepted by the buyers) for a period and amount not exceeding the period and amount stated in the policy schedule opposite the buyer's name.
- (b) *Open Account Policies*. Although somewhat similar to the above, these policies cover loss under open-account transactions, the amount of each invoice being declared and written off the total sum insured.
- (c) *Time Policies*. These guarantee, during a period up to twelve months, the solvency of specified customers to whom credit has been granted for goods sold and delivered. The premium is based on the largest amount of credit given to any customer at any one time, irrespective of the total credits given during the course of the year.
- (d) *Whole Account Policies*. Premiums are based in these cases on the total gross invoice value of goods sold and delivered during the period of insurance. Losses up to an agreed percentage of the total sales are borne by the insured, the insurers being liable for a proportion of the excess.
- (e) *Re-sale Loss Policies*. When a buyer fails, the seller occasionally takes back the goods which he has sold, and may then be unable to obtain the same price for them as when he first sold them. These policies cover a proportion of the loss sustained on any re-sale in this manner.

THE GOVERNMENT EXPORT CREDIT SCHEME, which is dealt with in Chapter 30, is also a form of bad debts insurance designed primarily to foster the export trade.

LIFE ASSURANCE

Under a contract of life assurance the assurer agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life. For instance, under an *endowment assurance* the policy moneys are payable on the life assured's surviving a period of years—*e.g.*, on his attaining the age of 60—or at his death should that occur previously; under a *whole life assurance* the policy moneys are payable at death only.

LIFE ASSURANCE PREMIUMS

The general principle on which premiums for life assurance are based

is the law of probabilities, which is closely allied to the principle of average—fundamental in all branches of insurance. If a sufficiently large number of lives is kept under observation for a number of years, and the deaths that occur in each year of age are accurately recorded, a mortality table can be compiled.

That much-misunderstood term, “expectation of life”, refers to the *average* subsequent duration of life of a *body of persons* of a given age, according to a given mortality experience. It is frequently misused in reference to a *single* life. The “expectation of life” is never used by actuaries in calculating rates of premium, but it may be legitimately used by medical officers as a guide in rating up lives that are not first-class, and for comparing the results of different mortality tables.

In translating the probabilities of life and death into monetary values, compound interest must be introduced. Thus, if the chance of dying at the end of a year of a life aged 40 is 0.035, the present value of a pound payable on his death at that time is £0.035 discounted for one year. In this way, by combining probabilities and compound interest, the *net* or *pure* premium is arrived at, and by making the necessary allowance or “margin of loading” for expenses of management, bonuses for with-profits policies, and dividends for shareholders, the *gross* or *office* premium is obtained.

Life assurance differs, however, from other branches of insurance, in that the premium once fixed for a particular contract cannot normally be altered, although the risk increases with age. Thus a level premium is payable throughout life, the excess premium over that required to cover the risk and expenses in the earlier years being accumulated at interest to provide for the deficit in later years, when current risk and expenses exceed the premium payable. This balance is known as the *policy reserve*, out of which may be paid surrender and loan values, and from which the amount of paid-up assurance may be calculated.

SURRENDER VALUES

The *surrender value* of a life policy is the amount which the assurers are prepared to pay at a particular time in total discharge of the contract. In normal circumstances it represents a large proportion of the reserve of the policy. Under whole life assurance (where the policy moneys are payable at death), endowment assurance (where the policy moneys are payable on a certain date, or at death, whichever occurs first) and similar policies, surrender values naturally increase with each payment of premium, though, of course, such increased value thereafter diminishes somewhat until another premium is paid, as *current risk* steadily increases. There is, however,

no direct relationship between such surrender values and the premiums paid, although some companies guarantee minimum surrender values based on a percentage of the premiums paid.

From the foregoing it should be obvious why a surrendering policy-holder cannot expect to obtain the return of all the premiums he has paid. He has been covered against risk during the currency of his policy, and this cover has to be paid for. Moreover, as in other branches of insurance, the fortunate policyholders who have not yet made any claims help to pay for the claims of their less fortunate associates.

Not all policies normally carry surrender values—*e.g.*, temporary assurances, on which the premiums are little more than sufficient to cover costs of current risk and expenses. Where, however, a surrender value exists, a loan value also generally obtains.

LOANS ON POLICIES

The *loan value* of a policy is the amount which the assurers are willing to lend on security of the policy, and is usually about 95 per cent of the surrender value, the balance of 5 per cent being retained by the company as margin for a year's arrears of interest.

PAID-UP POLICIES

The *paid-up policy value* is the amount to which the sum assured (and bonuses, if any) would be reduced at any moment if the assured requested a rearrangement of his contract so that no further premiums should be payable.

ASSIGNMENT

Life assurance policies are freely assignable. They may be sold, mortgaged or settled, the assignment usually being made by deed, notice of which, in duplicate, should be given to the assurance office. Notice of assignment thus given creates a legal assignment which would have priority over an equitable assignment, *i.e.*, one not formally notified to the assurers.

CLAIMS

Claims may arise by death or at maturity of the policy, and are payable on proof of the event and subject to verification of the title of the claimant to the policy moneys.

ANNUITIES

Most life offices do annuity business. They undertake, on payment of a certain amount, to pay the purchaser a specified annual sum, *i.e.*, an *annuity*, for the remainder of his life or for some other period, fixed or indeterminable in advance. The purchase price of the annuity varies with the size of the annuity and the age of the prospective annuitant. Naturally, the price to an elderly person is lower than the price to a younger person.

DEFERRED ANNUITIES. Where an immediate annuity is bought, the first payment of the annuity by the life office is made within a short period, *e.g.*, on 1st January following the purchase. It is, however, possible to buy an annuity, payment of which is deferred, say, for 20 or 30 years after the contract is entered into. The purchaser of the *deferred annuity* may pay a lump sum down at once and nothing more, or he may make annual payments over a period of years.

COMMON INSURANCE TERMS

PROPOSAL

This is the printed form on which a prospective insured—*i.e.*, a *proposer*—makes written application for the issue of a policy. It contains questions relating to the risk and to the proposer's insurance record, which must be answered by the proposer, who has to avow the truth of his statements in a declaration dated and signed by him.

In fire insurance the proposal form is frequently dispensed with, but it is usually required in respect of private house contents, shop and farming risks. The necessity for a proposal form is eliminated to some extent by the fact that other fire risks almost invariably require to be surveyed. The proposal form becomes the basis of the contract, in which it is usually expressly incorporated, except in the case of fire policies.

COVER NOTE AND DEPOSIT RECEIPT

This is a letter or printed form used in the fire and accident branches, and is issued to a proposer on receipt of a proposal, notifying him that he will be held covered from the date of the note until a policy has been issued or his proposal declined. The document stipulates that the cover is subject to the terms and conditions of the policy, the salient conditions of which should be printed on the cover note. In life assurance, cover notes are seldom used except for foreign business. Usually, no premium is paid at the time, but if a payment

on account is made, a deposit receipt is issued which constitutes a combined cover note and receipt.

FORM OF CONTRACT

In order that an action may be sustained on a contract of fire, accident or life assurance, *the contract need not be embodied in a policy*, though this is the invariable practice. Where there is no policy, there must, of course, be either written or oral evidence to support the action. A marine insurance contract, however, must be incorporated in a policy.

ENDORSEMENT

In fire, life and accident policies an endorsement is a special condition appended or affixed to the policy, to provide for a certain special requirement not otherwise found in the printed (standardised) text of the policy. An alteration of the policy properly effected by endorsement is deemed to express the particular intentions of the contracting parties.

WARRANTY

This is a promise by the insured that a certain condition shall be fulfilled, or one affirming or denying certain facts. If a warranty, whether material to the risk or not, is not literally complied with, the insurer may treat the contract as voidable from the time of the breach. The warranty need not be contained in the actual policy: it is sufficient if it appears in any further document which is, by reference, incorporated in the contract, *e.g.*, a proposal form.

REPRESENTATION

This is any statement made by a proposer or his agent, not being a warranty, which forms a portion of the premises from which the other contracting parties draw their conclusions either to accept or to reject the contract, and by which they are guided in fixing the terms and adjusting the conditions thereof. Unlike a warranty, a representation need only be substantially correct and to affect the validity of the contract must be material to the risk.

DAYS OF GRACE

Life policies contain a condition requiring payment of the premium within certain days of grace, normally thirty days, but where the

premium is unpaid at the end of that period the policies generally provide that the assured shall be protected under a non-forfeiture scheme. Most fire policies are renewable at a quarter day, fifteen days' grace being allowed, except in the case of short-period insurances. In accident business the days of grace vary, but fifteen days are usual; burglary policies usually keep to the quarter days, but the others spread over the year. In fire and accident policies, days of grace are not stipulated in the policies but are a custom of the business, which is recognised by the Courts and will be enforced by them, provided that the insured has not indicated his intention not to renew.

"EX GRATIA" PAYMENTS

These are payments made "without prejudice" to the insured in respect of losses of which the insurer is not legally liable or where liability is open to argument, and are common to all branches of insurance, except life assurance. Very often the insurers are morally liable for a claim not legally enforceable, as where there is an innocent misrepresentation by an agent, or a pardonable misunderstanding by an insured.

REINSURANCE

Two main reasons account for the utility of reinsurance, *viz*:

- (1) It is not wise for insurers to concentrate their commitments. They, therefore, so spread their risks that they are as numerous and as varied in character and location as possible, in order that the law of average may operate to reduce to a minimum the chance that their funds may be crippled by any single catastrophe.
- (2) Prudent insurers must as a precaution reinsure their less desirable risks so as to limit their losses. However, reinsurers must also receive a fair share of the good and average risks in order to maintain a sound reinsurance market.

Reinsurance is common to all branches of insurance, and may be effected either *facultatively* or by *cover* or *treaty*.

FACULTATIVE REINSURANCE

This signifies reinsurance of individual risks or part thereof, the reinsurer having the power of discriminative selection. The reinsurance may be against all the contingencies covered by the

original policy, or certain of them only. In marine and life business, a reinsurance policy is almost invariably issued, but in the fire and accident branches, policies are usually dispensed with.

COVER REINSURANCE

This is a form of reinsurance comparable with the open-cover method in direct marine insurance (see page 264). It is very similar to reinsurance by treaty, but the limits of protection are more restricted.

TREATY REINSURANCE

This type of reinsurance means reinsurance by an agreement between insurers and reinsurers whereby the reinsurers agree to accept during a specified period, with the option of declining, a certain proportion of any risk over the insurers' limit. No reinsurance policy or guarantee is issued, the contract being contained in a signed agreement which is, to all intents and purposes, a policy of insurance.

A reinsurance treaty is generally mentioned in terms of *lines*, e.g., a six-line treaty is one under which the insurers automatically obtain cover for six limits in addition to their own limit. If the insurers' limit were £2,000, they could reckon on a £12,000 cover from their treaty, and so could accept £14,000 on a risk without facultative cover. This six-line treaty might be subdivided amongst six reinsurers, each taking a line, or twelve reinsurers, each taking half a line. The insurers would bear one-seventh and the reinsurers six-sevenths of a loss on the basis of the figures just mentioned.

Under this type of treaty, the insurers may vary their limit or retention of particular risks, thus varying the reinsurers' shares of the risks concerned (*surplus* reinsurance). On the other hand, in *quota share* reinsurance, the insurers retain a fixed part of all risks within the scope of the treaty and reinsure the remaining part, e.g., they may retain one-fourth and reinsure three-fourths, all losses being shared in those proportions. Again, in *excess of loss* reinsurance, the reinsurers are liable for any amount of a loss only if it exceeds the insurers' retention, i.e., the insurers bear the smaller losses in full.

Part III

THE DISTRIBUTIVE TRADES

CHAPTER TWENTY-TWO

Distribution: Functions, Channels and Structure

The distributive trades form the last links in the chain of intermediary activities involving the transfer of goods from producer to consumer. Since production cannot be considered complete until the product is in the hands of the consumer, the work performed by the distributive trades must be viewed as a vital aspect of the process of production. Coal in the pit seam is of little value to the domestic user who requires it; when it reaches him through the wholesaler and retailer it has acquired added value resulting from place, time and possession utility.

PLACE OF THE DISTRIBUTIVE TRADES IN THE ECONOMY

The distributive trades in Britain employ 2·7 million persons, amounting to 11 per cent of the total employed population. (This figure may be compared with that of the U.S.A. where approximately 13 per cent of the employed population work in the distribution sector.) Distribution is an example of a "labour-intensive" industry, i.e., one in which there is a high use of labour with a complementary low rate of mechanisation and capital investment.

In 1977, 450,000 retail outlets were responsible for a turnover of about £34,000 millions of merchandise, i.e., approximately one-half of the gross national expenditure. 40,000 wholesale organisations, controlling some 55,000 separate establishments, employ about 0·75 million persons, 90 per cent of whom work in links with the home market. It has been suggested by some economists that Britain is "over-shopped" and that too many of the outlets in operation are in the "small-business" category, so that the average selling unit is unable to enjoy the advantages of the economies of large-scale operation, with a resulting loss of economic benefit for the consumer.

FUNCTIONS OF THE DISTRIBUTIVE TRADES

Distribution involves the sale of goods to *intermediate consumers*, i.e., those who buy for resale or for purposes of further manufacture, and *final consumers*, i.e., those who buy for the satisfaction in use to be derived from the use of those goods.

In a competitive market economy in which, by and large, production is geared to forward estimates of consumer demand, the distributive trades perform the following important functions:

- (a) They hold stocks of goods until required.
- (b) They provide variety in choice by promoting or displaying a wide selection of merchandise.
- (c) They add utility to goods by making them available for the consumer at times and places to suit him.
- (d) They provide vital market information relating to trends, etc., which can be valuable to producers and consumers.

McGarry, who has analysed distribution in terms of "the matching of segments of supply and demand", lists the functions involved in wholesaling and retailing as: *contactual* (the finding of buyers and sellers); *merchandising* (the fitting of goods to the requirements of the market); *pricing* (the selection of an appropriate price attractive to producers and consumers); *propaganda* (the conditioning of the market to a favourable attitude towards the goods); *physical distribution* (the transport and storing of goods); *termination* ("the consummation of the marketing process").

Performance of these and allied functions determines in large measure the structural pattern of wholesale and retail outlets and the configuration of channels of distribution.

CHANNELS OF DISTRIBUTION

A "channel of distribution" has been described as "the sequence of institutions listed in order of their participation as buyers, sellers or holders of products in providing the facility to move those products from producer to consumer", and "an institutional configuration for directing and supporting the flows from production to use, of things of value". More formally, the term "channels" is a description of *the paths taken by title to goods, i.e., legal evidence of rights of ownership, from point of production to point of consumption*. Thus, when goods move from the manufacturer (M) to the wholesaler (W), from him to the retailer (R) and from him to the customer (C), the course taken by title to the goods ($M \rightarrow W \rightarrow R \rightarrow C$) constitutes a channel of distribution.

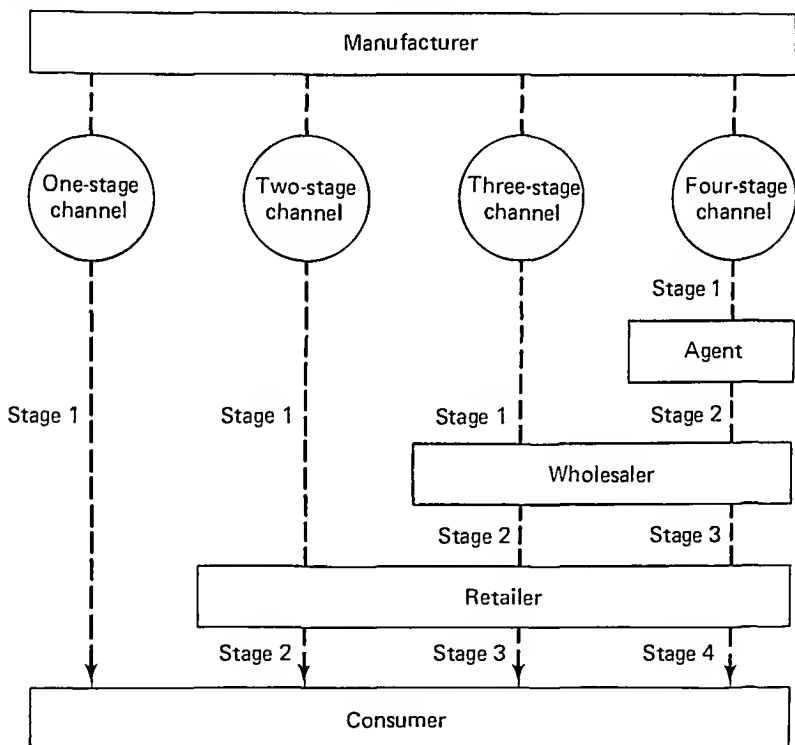
Channels may be classified according to the *number of stages* in ownership, thus:

- (a) A *one-stage channel* is constituted where the manufacturer supplies the consumer directly ($M \rightarrow C$).
- (b) A *two-stage channel* is constituted where the manufacturer

supplies the retailer directly and he in turn supplies the consumer ($M \rightarrow R \rightarrow C$).

- (c) A *three-stage channel* is constituted when, for example, the manufacturer supplies the wholesaler, who supplies the retailer who, in turn, sells to the consumer ($M \rightarrow W \rightarrow R \rightarrow C$).
- (d) A *four-stage channel* is constituted where, for example, the manufacturer supplies an agent, *i.e.*, a primary wholesaler, who supplies a secondary wholesaler, who supplies a retailer who supplies the consumer ($M \rightarrow W_1 \rightarrow W_2 \rightarrow R \rightarrow C$).

Channels of this type may be illustrated by the diagram which follows.



ACTIVITIES PERFORMED IN CHANNELS

The activities which are performed by the component elements of a channel of distribution have been categorised thus:

- (a) *Transit.* Goods must be directed and moved physically from point of origin to point of destination.

- (b) *Search.* Buyers and sellers must be made aware of the goods and must be brought into a market relationship with one another.
- (c) *Maintenance of inventories.* The carrying of inventories in appropriate quantities is essential if distribution is to be swift and economical.
- (d) *Persuasion.* Advertising campaigns and personal selling are required if goods are to be marketed so as to satisfy demand.

FUNCTIONS OF CHANNELS

In a market economy, in which market equilibrium price reflects conditions of effective demand and supply, marketing channels provided by the distributive trades fulfil a variety of functions, including the following:

- (a) *Routinisation of decisions.* Well-established channels create the possibility of a routine of decisions and resulting transactions, generally resulting in lower costs. Automatic re-ordering of merchandise, with a minimum of time and effort, is an example.
- (b) *Involvement in the pricing process.* Given the parameters of market supply and demand, agents are able to recommend retail prices and operating margins to the manufacturer.
- (c) *Provision of general market intelligence.* A continuous flow of information along distribution channels enables significant changes in fashion, for example, to be reported, researched and made the basis of manufacturing decisions relating to output and quality.
- (d) *Finance of business.* The carrying of stocks and the provision of trade credit affect the general financial activities of business. Thus, a wholesaler who allows credit to a retailer is actively participating in the finance of business operations.
- (e) *Minimisation of the number of transactions.* The role of intermediaries, such as wholesalers, results in a reduction of transaction costs and transport charges. This is illustrated in diagram form on page 305.

DESIGNING DISTRIBUTION CHANNELS

When designing manufacturer-consumer links, a number of basic requirements must be kept in mind. First, the channel, which provides the links, must provide for the physical transfer of the goods to the consumer in the minimum time. Next, the channel should allow for appropriate communications; in particular it should permit the swift

feedback of market information to the manufacturer. The channel should be so designed that it can be adapted with relative ease to changed market conditions.

Three steps in designing distribution channels may be delineated:

- (a) *Channel objectives and constraints must be determined with accuracy.* Customer characteristics, product properties and features, strengths and weaknesses of middlemen, the channels utilised by competitors and, finally, environmental characteristics, such as general economic conditions, must be analysed.
- (b) *Major feasible channel alternatives must be distinguished.* This necessitates a close examination of, e.g., the types of business intermediaries likely to be involved, the number of intermediaries who will be required at each stage in the channel flow and the price policies of those intermediaries.
- (c) *Alternative channels must be evaluated.* The basic criteria of the evaluation should reflect: economic values (i.e., costs, returns related to various channels); control requirements (i.e., channel alternatives as sources of possible marketing conflict); response requirements (i.e., channels allowing flexibility). A well-known measure used in estimating the economic return from channel use is *return on investment*: thus,

Let R_x = return on investment associated with the use of channel x ;

S_x = estimated sales associated with the use of channel x ; and

C_x = estimated costs associated with the use of channel x .

$$\text{Then } R_x = \frac{S_x - C_x}{C_x}$$

Other things being equal, the channel with the highest R_x will be the preferred alternative.

WHOLESALE STRUCTURE

Wholesaling (see Chapter 23) involves the sale of goods in quantity for resale. It may be described in more formal terms as selling to other business organisations for business use or for resale, generally in bulk and below prevailing market retail prices.

The functions of the wholesaler, in relation to the manufacturer, include: establishing links with retail outlets, providing advice on the market, reducing the manufacturer's warehousing capital costs and costs of physical distribution. In relation to the retailer, the wholesaler performs the following functions: he researches and anticipates customers' demands, assembles merchandise from many

sources, buys in bulk and maintains stocks which can be drawn on to meet retail demand, delivers, grants credit.

Wholesalers may be classified as "full-service" or "limited-service". Full-service wholesalers perform a number of services for their customers, *e.g.*, controlling warehouses and stocks and delivering merchandisc. They usually carry a wide assortment of goods, in which case they are known as "general wholesalers", as distinct from "specialty wholesalers" who carry a very narrow range of lines. Limited-service wholesalers tend to handle only fast-moving merchandise in, *e.g.*, cash and carry warehouses.

Another classification of wholesaling has been made by Tietz, thus:

- (a) Wholesaling based on *the storage of goods*: (i) without customers calling (*e.g.*, dealers delivering builders' materials); (ii) with customers calling (*e.g.*, wholesale merchants serving small, independent retailers).
- (b) Wholesaling based on *the disposition of goods*: (i) without customers calling (*e.g.*, exporting agents supervising the shipping of goods); (ii) with customers calling (*e.g.*, wholesalers operating in trade fairs).

The principal areas in which wholesalers in the U.K. are active include groceries and provisions, metals and petroleum products. In 1977 the book value of wholesalers' stocks was estimated to be around £4,000 million. Trends apparent in British wholesaling during the past decade have included: growing specialisation; closer co-operation with retailers; improvements in operational techniques, in particular, the use of computer-controlled warehousing machinery.

A prominent role in the wholesaling structure of the U.K. is occupied by the *Co-operative Wholesale Society* (C.W.S.), the central organisation established by the retail co-operative societies to serve their trading needs. The C.W.S. was the result of a merger in 1973 of the Co-operative Wholesale Society, Ltd, and the Scottish Co-operative Society Ltd. It is now the country's largest wholesaler, with 10 per cent of the U.K.'s wholesale trade and 15 per cent of the entire wholesale trade in grocery and provisions. (Additionally, it is the largest co-operative productive organisation in Britain, with 120 factories.) It employs almost 30,000 persons. Annual sales were around £1,100 millions in 1977, which represented 1.2 per cent of the gross national product. Goods to the value of £325 million were produced in 1977 in C.W.S. factories. The organisation operates some of the U.K.'s most advanced warehousing facilities, such as the Cumbernauld Warehouse. Its activities are divided into four main areas: food, non-food, finance and services division.

PHYSICAL DISTRIBUTION MANAGEMENT

In recent years the concept of a unified approach to physical distribution management (P.D.M.) has gained increasing acceptance among manufacturers, wholesalers and retailers. P.D.M. has been described as the science of business logistics "whereby the proper amount of the right kind of product is made available at the place where demand for it exists at the time it exists". It is based on a *co-ordination of all the decisions and activities related to the flow of products from manufacturer to consumer.*

A P.D.M. analysis of distributive operations in wholesaling would involve matters such as cost systems, computerised control systems, institutional systems (*i.e.*, transportation, warehousing, etc.) and activity systems (*i.e.*, internal and external communication systems including those related to fixed handling, such as warehousing, and moving facilities, such as transport). Mathematical models have been constructed and utilised so as to suggest optimum arrangements of P.D.M. system, with particular emphasis on inventory control and handling systems. The increased use of computer-controlled wholesale warehousing systems is a direct result of advances in computer technology which has enabled data processing involved in wholesale operations to be carried out swiftly and accurately.

RETAILING STRUCTURE

Retailing (see Chapters 24 and 25) involves sales to the ultimate consumer. In more precise terms it may be described as those institutions and procedures through which the final consumer obtains services and goods in exchange for money.

The general functions of the retailer include: the provision of goods when and where they are needed (*i.e.*, the creation of time and place utility); the storage of merchandise; the communication to the consumer of information relating to merchandise characteristics; the promotion of merchandise and the consequent extending of consumer choice; the provision of information to wholesalers and manufacturers relating to variations of effective consumer demand in response to price changes, innovatory merchandise, etc.

Retailing structures may be classified in a variety of ways, *e.g.*: according to the type of goods handled; according to the width of selection offered; according to the services provided by the store; according to organisational framework; according to ownership. The classification adopted in Chapter 24 is based on the following types of outlet, each of which is defined and considered at appropriate places in that chapter:

- (i) independent stores;

- (ii) multiples;
- (iii) department stores;
- (iv) co-operative stores;
- (v) supermarkets;
- (vi) hypermarkets;
- (vii) superstores;
- (viii) mail order organisations;
- (ix) discount stores;
- (x) other outlets, *e.g.*, mobile shops, markets.

Important features of the changing retail scene in the U.K. during the past two decades include: the growth of self-service facilities; the development of very large retail outlets, *e.g.*, superstores; the growth of shopping centres; the development of leasing within stores; the diversification of types of merchandise sold in traditionally "one-line" stores; the spread of centralised buying procedures.

The diagram below indicates the percentage shares taken in the retail trade of the U.K. by various types of store for the years 1971, 1973 and 1977.

26.6	26.1	28.5	Grocers and other provision dealers
16.7	16.1	16.6	Other types of food retailers
15.2	15.5	14.3	Clothing and footwear stores
10.0	10.9	9.3	Durable goods stores
25.4	25.1	25.1	Departmental stores
6.1	6.3	6.2	Miscellaneous non-food stores
1971	1973	1977	

Shares by percentage of various types of retail outlet in the retail trade of the U.K.

Source: Central Statistical Office and
Department of Trade

PRODUCTIVITY IN THE DISTRIBUTIVE TRADES

Productivity may be described as a measure of goods or services produced per unit of labour, capital, or the two combined. (The ratio of output to labour *plus* capital is a *total productivity* measure; the ratio of output to labour *or* capital is a *partial productivity* measure.)

Productivity in the distributive trades is a direct reflection of factors such as the efficiency of labour, the amount of investment, etc., and certain important environmental influences. Among significant environmental influences are: the trade cycle; the general state of the labour market and labour costs; total number of shops; market size; customer tastes and shopping habits; per capita disposable income. It has not been easy to establish a generally-acceptable measure of productivity in the various fields of distribution. Some widely-used measures are set out below.

In the area of wholesaling a measure of efficiency employed is an index developed by Alderson. The index is based on the item flow over number of suppliers plus number of customers. Item flow equals number of individual transactions if manufacturer and retailer were to trade with each other directly. The index is relatively low where only a few products are sold (so that item flow falls) or where there are few customers (which may result in direct buying).

In the retail trade a measure of productivity employed is:

$$\text{Rate of Productivity} = \frac{\text{Input Index}}{\text{Output Index}}$$

where

$$\begin{aligned} \text{Input Index} &= \text{Unit sales per shopping hour} \\ &= \frac{\text{Number of retail sales}}{\text{Number of shopping hours}} \end{aligned}$$

and

$$\begin{aligned} \text{Output Index} &= \text{Man-hour equivalents} \\ &= \frac{\text{Total expenses of distribution}}{\text{Average hourly wage rate}} \end{aligned}$$

Suggestions made for increasing the rate of productivity in distribution include: increasing the scale of operations in distributive outlets; increasing investment; improving, in regular and methodical fashion, techniques of management and selling; adjusting shop capacity in relation to market demand.

FUTURE DEVELOPMENT IN THE DISTRIBUTIVE TRADES

Within the existing pattern of distribution in Britain may be discerned the determinants of the pattern of future development.

That pattern, which will reflect wider, general changes in economic and social development as a whole, will mirror:

- (1) *Changes in the economic status, life style and expectations of the consumer.* These changes will reflect movements in the level of disposable income, leading to altered patterns of demand and consumption. Improved methods of communication may lead to demands for round-the-clock shopping.
- (2) *Changes in the physical surroundings of the retail operation.* Changes in the pattern of urban development will affect the siting of retail outlets. A growth of "one-stop" shopping units and shopping precincts, a development of out-of-town shopping areas and the transfer to the suburbs of some large stores seem possible. A growth of "shopping-at-home" facilities through the medium of visual display home information units may result as a reaction to crowded shopping centres and as a response to computerised facilities linking store and home.
- (3) *Changes in the composition of the selling unit.* The large retailing unit is likely to grow in size; the small-scale unit is likely to decline further. Self-service techniques, own-brand selling, a partial integration of wholesaling and retailing and the appearance of new forms of selling challenging some existing forms may emerge from the current pattern of distribution.
- (4) *Changes in managerial techniques.* The growth of automated processes, the integration of concepts of P.D.M. and electronic data processing will necessitate changes in the nature of management control, both in the wholesale warehouse and the retail store.
- (5) *Changes in peripheral matters.* A possible codification of consumer legislation, an intensification of town planning restrictions, changes in the credit and banking systems and a growth of state activity within the market system will have far-reaching effects on the structure and functioning of the distributive system.

LONG-TERM CHANGES IN THE PATTERN OF DISTRIBUTION

Several theories have been advanced to account for the rise, development and decay of types of distributive organisation; among them are the following:

- (a) *The "evolutionary theory".* According to this argument only the fittest tend to survive in the long run. Organisations which fail to respond correctly to a changing environment will not survive for long. The inability of some types of retail outlet to react appropriately to changed patterns of demand and shopping habits, and their subsequent disappearance, can be cited as an example of failure to adapt.

- (b) *The "wheel of retailing theory"*. This interpretation of development in distribution, associated with Professor Malcolm McNair, suggests the existence of a cyclical pattern of change. Innovation in selling organisation is the first stage in the cycle and is followed by general acceptance of the organisation by consumers. Later comes pressure from competitors offering novel and attractive methods of selling. This tends to result in the organisation's failure to respond to that pressure. There is a movement by the organisation to a lower level of trade and, eventually, the organisation disappears, so that the cycle is completed. The appearance of the supermarket, the growth of the discount store, have been interpreted as innovatory challenges to forms of selling which, in themselves, were responses to even earlier types of retail organisation.
- (c) *The "accordion theory"*. This theory has been formulated by Professor Stanley Hollander, who summarises it thus: "The history of retail development seems to demonstrate an accordion pattern. Domination by general line, wide-assortment retailers alternates with domination by specialised, narrow-line merchants. Neither the pattern's universality nor its existence can be proved definitely (since there are no valid historical statistics on merchandise assortments), but many astute students of retailing history have discerned these rhythmic oscillations."

CHAPTER TWENTY-THREE

The Wholesale Trade

The wholesaler purchases goods in large quantities from manufacturers and re-sells to retailers in smaller quantities. The true wholesaler is himself neither a manufacturer nor a retailer but acts merely as *a link* between the two.

THE FUNCTION OF THE WHOLESALER

The activities of the wholesaler are not confined merely to the operations of buying and selling: it is also his business to forecast, to stimulate and to interpret the desires of his customers. He performs two very useful functions: he helps the manufacturer who does not want the trouble of supplying goods in small quantities to retailers; and he helps the retailers by supplying him with goods in the qualities and quantities he requires, so making it unnecessary for him to carry heavy stocks.

FUNCTIONS OF THE WHOLESALER IN RELATION TO THE MANUFACTURER

By buying in large quantities, the wholesaler enables the manufacturer to benefit from the economies of large-scale operating. The wholesaler obtains orders from numerous retailers and meets them from stocks supplied in bulk by the manufacturer. In this way the manufacturer is saved the expense of obtaining a large number of small orders and despatching many small parcels of goods. Also, the orders given by wholesalers to manufacturers indicate the trend of public taste and bring to the notice of the manufacturer any changes in demand, so permitting him to regulate his production accordingly.

The wholesaler performs an even more important service to the manufacturer by relieving him of the necessity of carrying large stocks, thus enabling him either to release his capital for further production or to carry on his business with less capital than would otherwise be necessary. Largely for this reason manufacturers produce principally to order.

FUNCTIONS OF THE WHOLESALER IN RELATION TO THE RETAILER

To be successful a retailer must, in the majority of cases, carry a wide range of goods, but owing to lack of space and capital he cannot hold

large quantities of each type of commodity which his customers require. The wholesaler fills this breach in that he constitutes a source to which the retailer may turn for replenishment of his stock in small quantities at frequent intervals. The wholesaler thus relieves the retailer as well as the manufacturer of the trouble and expense of holding large stocks and enables him to carry on business with less capital than would otherwise be necessary. Also, the stocks held by wholesalers enable retailers to obtain supplies more quickly than they could from manufacturers, for, as already stated, manufacturers often produce only to satisfy orders actually received. Without the wholesaler, therefore, retailers would of necessity have to wait longer for the execution of their orders or, alternatively, they would have to place their orders sooner and this, in many cases, would be impracticable.

Another direction in which the wholesaler assists the retailer is in passing on to him some of the advantages of specialisation. The retailer, carrying a varied stock of goods, cannot have expert knowledge of conditions in the market for each. The marketing function is performed by the wholesaler who specialises in one line of goods and is able to take advantage of favourable price changes.

Wholesalers in some cases help to keep manufacturers informed of changes in demand. In the same way, they bring to the knowledge of retailers new types of goods for which a market may be made.

Still more important is the financial assistance given by wholesalers to retailers in those trades where wholesalers regularly allow credit to their retail clients. This has the effect of increasing the working capital of the retailer as he can obtain his goods on credit and, by selling on a cash basis, can pay the wholesaler with the money received from his customers.

To a certain extent, the amount of credit allowed by wholesalers depends on the class of goods dealt in. A wholesale draper or wholesale jeweller allows more and longer credit to retailers than, for example, a wholesale tobacconist or a wholesale ironmonger. Generally speaking, the degree to which wholesalers grant credit depends upon: (a) whether the retailer gives credit; (b) whether the retailer has to carry large or small stocks; (c) the rapidity of the retailer's turnover.

When the retailer gives extensive credit to his customers or when he has to carry heavy stocks or when his stock is turned over slowly, he needs a proportionately larger working capital and, consequently, he expects and usually receives credit from the wholesaler.

WHOLESALE AND RETAIL COMBINATION

An aspect of the movement towards *integration*, *i.e.*, combination of different stages in the marketing function, is the tendency for the functions of wholesaler and retailer to be combined in one business. Usually where this occurs, the wholesale side has developed from the retail with the main object of attaining economies in buying. In other cases, the wholesale function has been the earlier, and the retail side has been set up because the wholesaler has attracted such a large clientèle of buyers outside the trade that he has found it convenient to establish a special department to deal with their custom, or because he has seen the need in a certain district for a retail shop which he could conveniently run as part of his business.

In the majority of cases, however, the association of the wholesale and retail function has developed as a result of retailers buying direct from manufacturers, *i.e.*, becoming their own wholesalers, in order to eliminate the middleman's profits. Large retailers such as supermarkets buy in bulk direct from producers and often themselves supply their own branches. Where this is possible the combination is advantageous, particularly in terms of large discounts. The small retailer, however, usually finds it more profitable to employ the services of a wholesaler or cash and carry warehouse and a wholesaler can usually offer a larger range to the retailer than a manufacturer.

MANUFACTURING AND WHOLESALE COMBINATION

A successful manufacturing concern frequently decides to do its own selling to retailers, thus combining the functions of manufacturing and wholesaling. (An important innovation of recent years has been the use of "caging" by manufacturers, whereby the manufacturer loads goods into collapsible steel cages which are transported directly to retailers' premises where they become, without any alteration, point of sale units. It has been estimated that the use of caging can add another 1.5 per cent to a retailer's selling area.) Conversely, wholesalers with large businesses have found it profitable to manufacture some or all of the commodities which they formerly obtained from manufacturers. In some cases the two functions are combined by the amalgamation of a wholesale business with a manufacturing concern. But in neither case does the manufacturer entirely eliminate the expenses of the wholesaling function. Indeed, in the majority of cases he still has to incur practically the same gross expenses of distribution and advertisement, though he is able to effect certain economies, *e.g.*, the cost of transport from factory to warehouse, and thus to divert to himself part at least of the

wholesaler's profit. In addition, his trading risks on changes of fashion, etc., are multiplied. The most notable examples of manufacturers serving the retailer direct are found in the case of "branded" goods (*e.g.*, Ovaltine, Shell, etc.), where there is a ready and steady sale without any need for the services of the wholesaler.

Obviously the manufacturer's main incentive to "direct selling", *i.e.*, sales made direct to the consumer, is the possibility of obtaining for himself the profit usually made by the wholesalers and retailers.

Certain general rules may be laid down in this respect:

- (1) Direct sales are unlikely to be profitable unless the volume of business justifies the setting-up of a separate sales organisation.
- (2) The saving of time by direct sales is advantageous where the product is perishable. But the producer must be quite certain of a quick sale.
- (3) A business producing a varied range of goods is more likely to derive benefit from direct selling than one which produces only one article.
- (4) The larger the size of the average order the greater, as a general rule, will be the benefits of direct selling.
- (5) Direct selling is seldom profitable in the case of a purely seasonal commodity, since the sales organisation will lie idle during the slack period, unless another line can be run during this period.
- (6) A product that requires considerable technical knowledge on the part of salesmen (*e.g.*, accounting machines) is a suitable subject for direct sales, since the concern's own salesmen are best equipped to convince the consumer.
- (7) Where the elimination of middlemen effects a considerable saving, a competitive advantage can be obtained by reducing prices.

IS THE WHOLESALE "LINK" NECESSARY?

It is frequently contended that the functions of the wholesaler could be dispensed with and that the producer and retailer could between them perform the duties of the middleman. In general, to the small retailer and to the small manufacturer the wholesaler seems essential. By operating on a large scale he relieves them of innumerable duties which they would find it expensive and difficult to perform. In the absence of the wholesaler, as has been seen, the retailer would find it necessary: (*a*) to hold large stocks of a variety of goods, thus locking up his capital; (*b*) to assemble these goods from a number of manufacturers or producers, probably widely scattered; (*c*) to arrange for the carriage, packing and grading of the goods; and (*d*) to bear the risks of price fluctuations and changes in fashion. It is the

risk-bearing which, in the majority of cases, is the deciding factor. The large retail businesses, the supermarkets, large departmental stores and multiple-shop concerns, are usually in a strong enough financial position to bear these risks and it is in such businesses that the tendency to eliminate the wholesaler is most prominent. Moreover, they have a large turnover which enables them to buy in bulk with less risk of the stock being left on hand owing to changes in demand, and they have large warehouses in which to store a variety of goods. Some of them, it is true, may need the financial backing of the wholesalers and the credit facilities extended by them, but, even when they are left with stocks on hand for which the demand has fallen, they are in a position to advertise on a large scale and can promote extensive "sales", during which they may be able to get rid of their stocks with little, if any, loss.

Similar advantages and disadvantages accrue to the manufacturer who performs his own wholesaling. The disadvantages may broadly be considered as a loss of those services which the wholesaler renders to the manufacturer, whilst the advantages are chiefly those of independence and the saving of the middleman's profits and expenses.

THE CONTRIBUTION OF THE WHOLESALER TO ECONOMY OF EFFORT

An important economy effected by the wholesaler is illustrated in the diagrams below. Diagram A shows the contacts necessary where three manufacturers (M) trade directly with three retailers (R) without the use of an intermediary wholesaler. *Nine* separate contacts are required ($M \times R = 9$). Diagram B shows the contacts necessary where the three manufacturers employ the services of a wholesaler (W) who contacts the retailers. In this case only *six* contacts are required ($M + R = 6$). The use of the wholesaler has reduced the volume of work required in order to establish the contacts.

SOURCES OF SUPPLY

The sources from which the wholesaler obtains his supplies must, of course, depend upon his particular line of business, but, in general, the chief of these are:

- (1) The home grower for perishable produce.
- (2) The home manufacturer for manufactured goods.
- (3) Produce exchanges for commodities such as hops, grain and metals.
- (4) Commercial sale rooms for coffee, spices, etc.

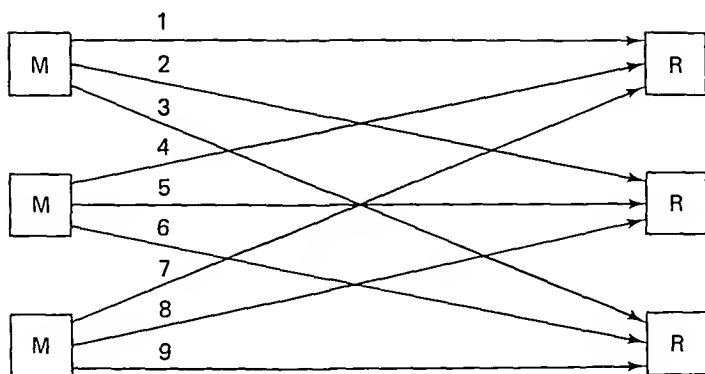


Diagram A: nine contacts necessary

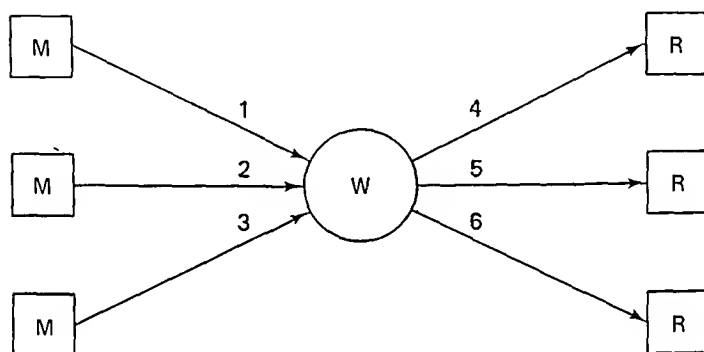


Diagram B: six contacts necessary

- (5) Import agents for overseas produce and manufactures obtained by direct supply.

It is the wholesaler's business to seek the most satisfactory sources of supplies and to ensure prompt availability to his customers.

THE WHOLESALER'S ORGANISATION

As wholesale merchants buy goods in quantity their undertakings are necessarily on a large scale and require careful organisation. This organisation, in its broader aspects, closely resembles that of a big departmental store, the business being divided into departments, each of which forms a separate unit under the charge of a departmental manager.

The departments fall into three divisions—administrative, buying and selling. The administrative staff is concerned with finance and accounts (including credit), correspondence, records, filing and

general administration. The number and extent of the other departments vary with the size and type of business, but generally they include the publicity department, the warehouse where the goods are stored, the despatch department which includes also the invoice department, and the packing sections.

THE WAREHOUSE

As the wholesale merchant sells almost exclusively to the retail trade, the question of premises is not as important to him as it is to the retailer. The main consideration is that the premises should be reasonably accessible to trade customers, and conveniently situated for the delivery and despatch of the type of goods stocked by the wholesaler. In some cases, particularly for goods of a special or technical nature, elaborate display arrangements may have to be made.

Generally, wholesale warehouses are classed according to the type of goods in which they deal. There are provision and grocery warehouses for such goods as tea, wheat, flour and coffee; drapery and clothing warehouses dealing with cottons, woollens and other textile products; timber yards, hardware warehouses, furniture warehouses, and so on in almost infinite variety. There are also subdivisions of these various types. In the woollen trade, for example, there may be wholesalers dealing exclusively in knitwear, others specialising in carpets and so on.

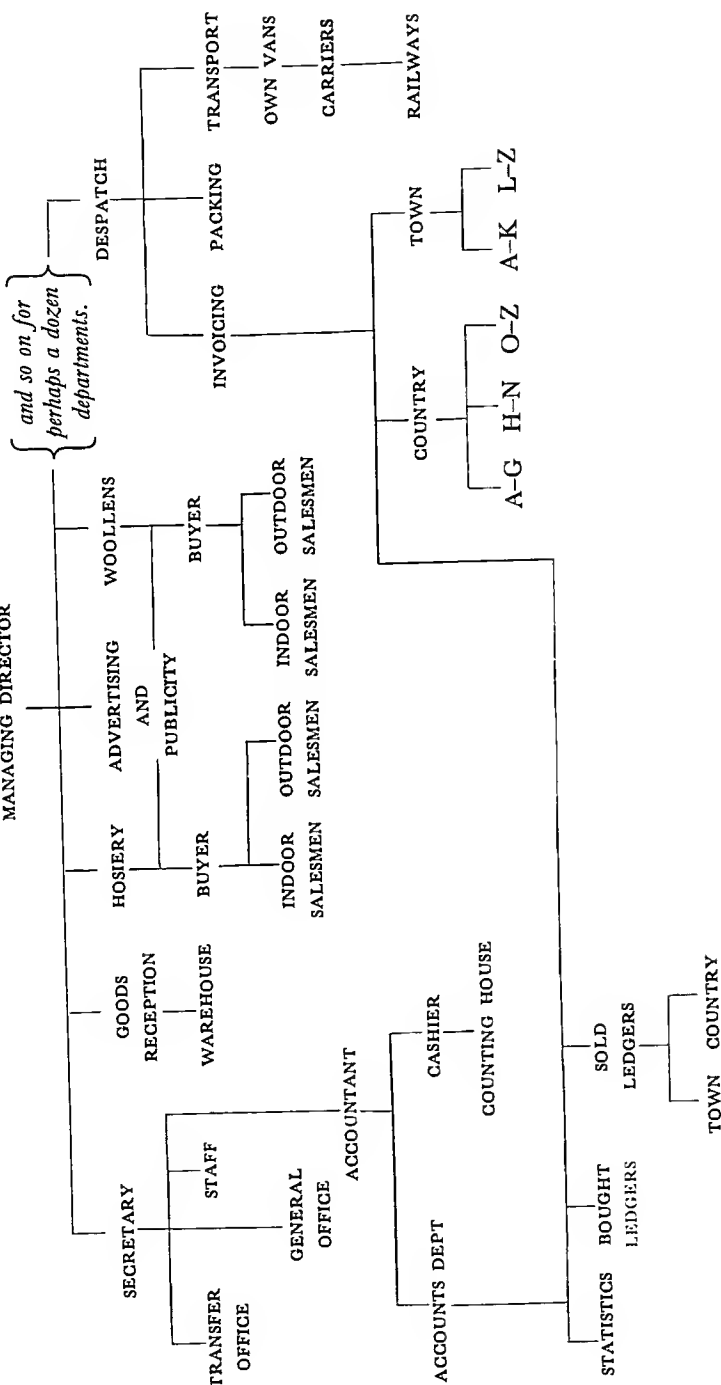
An important development in wholesaling warehousing in recent years has been the growth of the "cash and carry" warehouse, which is, essentially, an application of self-service techniques to wholesaling. It was introduced to Britain in 1955. Today, over 500 warehouses, with an average size of 11,000 square feet (1,022 square metres) and an annual turnover in excess of £1,250 million are in operation. Identity cards are issued to bona fide retailers and covered loading bays are available for their vans. Trolleys are collected at the entrance, the warehouses are well signposted and cash check out points are available. Benefits to the wholesaler include a reduction of costs relating to transport, representatives' salaries and clerical work. The retailer benefits from savings in time and storage space, smaller financial investment in stock and a reduction in administrative work relating to despatching orders, checking deliveries and settling accounts.

Although as a general rule the wholesaler specialises in one class or group of commodities, there is considerable variation as between wholesalers in the extent to which they specialise. Some, for instance, sell only tobacco and cigarettes; others might add to this the selling of

ORGANISATION OF WHOLESALE WAREHOUSE (SOFT GOODS)

BOARD OF DIRECTORS

MANAGING DIRECTOR



confectionery, and so on. Again, one wholesaler may stock only one article, especially if he is the sole distributing agent for that product, whereas another may stock articles of extraordinary variety. In the grocery trade it is quite common to find wholesalers who distribute almost the whole range of groceries commonly stocked by retailers and even wines and spirits, and the same applies to the ironmongery, drapery and other trades.

There are considerable differences, too, between the wholesale concerns dealing in raw materials and those interested in manufactured goods. The latter often hold small stocks. Their warehouse is little more than a showroom and may hold either sufficient stock to last only for a few days or merely samples of the various items of merchandise that the wholesaler is in a position to supply. In such cases, the orders may be fulfilled from the wholesaler's own stocks or sent direct from the manufacturers or from wholesale suppliers, or partly from one and partly from the other.

In the raw materials trades, conditions are different, especially in the trade of imported materials which have to be bought up by the wholesaler as the shipments arrive, thus entailing the holding of large stocks. Here, again, conditions vary. In the tea trade, for instance, the wholesaler draws his stocks from a bonded warehouse and is thus relieved of the necessity of maintaining large premises himself. In the meat trade, the meat must be kept in special "cold storage", while in the milk trade the reverse conditions are found, the storage required being only sufficient to hold one or two days' supply.

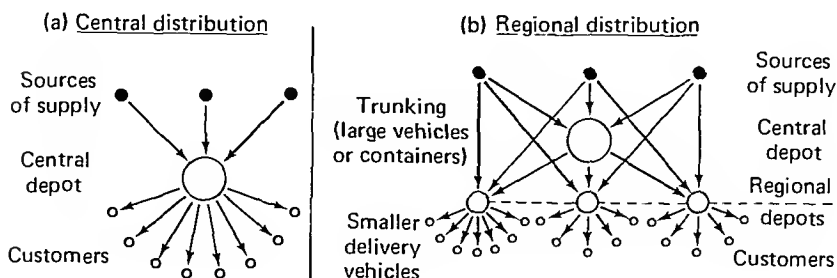
LOCATING THE WAREHOUSE

The main questions to be answered are:

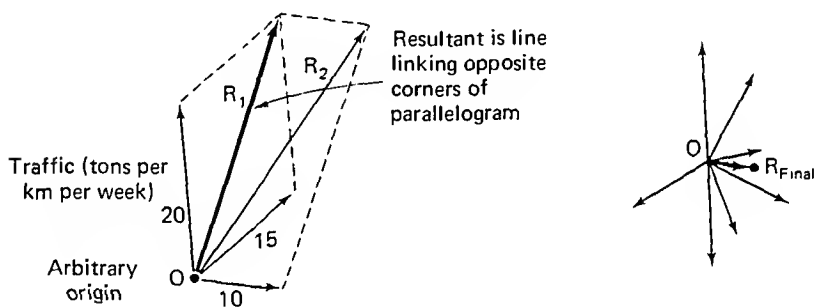
- (1) *Choice of Site*—whether the warehouse should be close to the sources of supply, or situated as close as possible to the customers.
- (2) *One large depot or several smaller ones.* One large warehouse is usually cheaper to operate per square metre of usable space but this can considerably increase delivery costs. It is often better, where large quantities have to be distributed over a large area, to "trunk" goods to regional depots or satellite warehouses where they are broken down for local delivery. The alternatives are contrasted in the diagram which follows. The type of goods and the location of customers are usually the determining factors.

Mathematical techniques have been developed for indicating the best warehouse location. Direction and volume of traffic from an arbitrary point are plotted as vectors. The resultant vector line

(found by scale drawing or trigonometry—see diagram below) from resolving any two is then resolved with a third, and so on until only one vector line remains; the other end of this line from the arbitrary



point chosen as the origin represents the point from which transport costs (in terms of ton-miles) are reduced to a minimum.

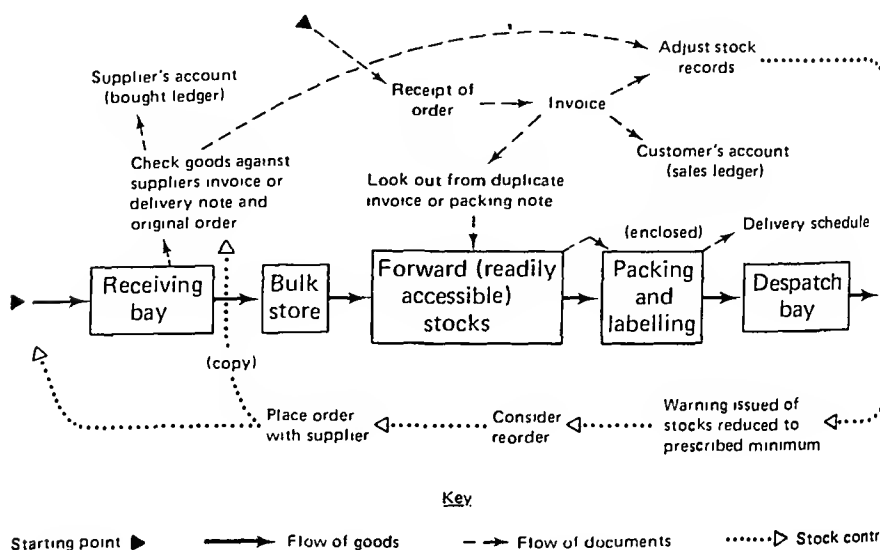


If several regional depots are favoured (alternative 'b'), then vectors pointing in a similar direction can be grouped and each group resolved separately.

While such calculations can give some indication of where to look, the actual choice of site will be determined largely by the availability of land of the right type and size (or suitable ready-built warehouse accommodation), the price being asked, governmental or local authority planning and building restrictions, the availability of labour and the ease of access for the transport vehicles required. Warehouse requirements should be foreseen and planned many years ahead as negotiations and preparatory work before occupation tend to be protracted.

ORGANISING THE WAREHOUSE

The work flow can be indicated in diagrammatic form.



The planning of the staff, machinery and space required to ensure the smooth operation of the warehouse should be based on careful work and flow measurement. This needs to be prefaced by a clear understanding of what work is involved and why.

Little can usefully be said in general terms on details of organisation and layout as these must be determined by the type of goods handled. Nearly always, the following will need to be considered.

- (1) *Mechanical handling.* Considerable saving of labour and time is often possible if the traditional lifts, hoists, hand-barrows and muscle-power are replaced by power-operated mechanical handling machinery. Movement predominantly in a fixed direction can be economically handled by fixed overhead trackways, while fork-lift trucks can move goods in any direction if stacked on hollow wooden pallets into which the forks on the front of the truck can engage. (The pallet is often left by the supplier as if it were part of the packaging and empty pallets are collected later.)
- (2) *Precautions against fire.* The advice of the fire brigade authorities should be sought (and heeded) at the planning stage, on safe layout, fireproof doors and emergency exits as well as on automatic and hand-operated fire-fighting equipment.
- (3) *Precautions against mistakes in invoicing and packing.* The best

precautions are a stable and well-trained warehouse staff whose members can read invoices and bin labels readily. Experience has shown that mistakes are also reduced if items are stored in a logical, readily understood sequence (*e.g.*, alphabetical) and clearly labelled—both on the item itself, if possible, and the storage bin or rack—with an unambiguous verbal title or description and *not* merely a location or code number. If such numbers are needed (as they will be for computerised invoicing) they should be allocated in a way that at least indicates the category to which the item belongs and, if possible, places it in its natural order within the category.

(4) *Precautions against fraud and theft.* Care in staff selection and vigilance, particularly over receipt and despatch of goods, are called for. Access to stocks should be confined to authorised warehousemen and supervisors. Particularly valuable items will need particularly careful storage, for instance in separate, locked cages with the key kept in a secure place and booked in and out each time it is used.

(5) *Precautions against deterioration and damage.* The following will help:

- (a) Careful instruction of staff in safe handling methods.
- (b) Careful observation and elimination of unnecessary hazards, such as steps, dark corners, defective machinery, etc.
- (c) Segregation of goods needing special storage conditions such as refrigeration, air conditioning, protection from frost, etc.

(6) *Exceptions.* Any system must allow for exceptions to the normal flow and must be capable of handling the disposal of damaged or unsaleable stock, for returns, replacement of defective goods (without returning defective items to the main stock), claims against suppliers, and urgent or priority orders.

THE AUTOMATED WAREHOUSE

Technological advances have made possible the introduction of a high degree of automation into the warehouse. Thus, the use of stacker cranes and gravity flow racks is found in many warehouses where high-volume storage presents difficulties of space. Feeding and retrieval lanes are preselected by computer so that the crane is directed from one location to another with a minimum of delay and congestion in shelving areas. Fully-computerised warehouses include a computer-controlled order-picking unit which passes instructions to conveyors and stacker machines, sorts goods on the basis of retailers' orders received, despatches goods with invoices and updates stock files so that stock control is accurate.

WHOLESALE ADVERTISING

In the wholesale trade, as in any other branch of business, increased sales are usually the aim. How and when the wholesaler shall push his goods must depend on his own judgment, but certain methods are common to all. Wholesale advertising is directed mainly to "the trade". For much of his business he relies upon advertisements in his trade journals and on direct mail advertising by the issue of circulars, catalogues and price-lists; this is probably the most productive method available, especially for those trades dealing in standardised goods.

In all concerns of any size there is a separate publicity department employed in making up lists and catalogues for advertising purposes. The department gets its information from the buyers of the various departments and produces not only a complete catalogue for the whole of the firm's goods, but also catalogues and price-lists special classes of goods and modified lists for seasonal sales campaigns.

Finally, there is the important sales approach of press publicity. In the wholesale trade, press advertising is usually confined to the various trade journals circulating the retail trades. The wholesaler does not advertise to the consumer, but where he does establish a direct link with the consumer he is acting usually in the capacity of a mail-order retailer, unless the advertisements specifically ask the public to place orders through retailers.

"BRANDED" GOODS

Advertising to the general public, either by wholesalers or manufacturers, requires the assignment to the goods of some mark or description—"brand" as it is called—that will enable the public readily to identify them as the goods which they have seen advertised. It would obviously be useless for a wholesaler dealing in shirts to advertise indiscriminately the advantages of wearing those garments. He would be spending money to the advantage of all shirt-dealers. What he does is to register a trade name for the shirts in which he deals and then to advertise under that name or brand. Probably he will buy his shirts from several manufactures, but he will sell them all under one brand.

There are many advantages attaching to the registration and use of trade-marks and names, the important ones being as follows:

- (1) A special demand for the branded goods can be created by means of an intensive advertising campaign.
- (2) A campaign can be entered upon with the knowledge that there will be no competition in that particular class or line of goods, so that the advertiser may reap the whole fruits of his efforts.

- (3) The price fixed or recommended by the manufacturer can be shown in advertisements so that consumers may know that they are not being charged an exorbitant price by the retailer.
- (4) In order to maintain the good reputation attaching to the branded goods, the manufacturer is compelled to maintain their quality.
- (5) Once the brand has been brought to public notice, the cost of selling falls, for retailers have sufficient confidence in the goods order without inspection of samples or the persuasion of salesmen.

The wholesaler is not the only one who benefits from this form of publicity. The retailer, too, shares in the benefits. He derives the advantages of a national publicity campaign which brings more customers to his shop. Further, he is assured of a more or less stabilised demand for the branded goods which have been brought to the public notice.

EXECUTION OF ORDERS

Orders for goods may be received either through the post, through representatives or by visits of customers to the warehouse. The orders are received by the administrative section by whom copies are made, and the originals are filed in a special file kept for orders received but not executed. This system of filing can be subdivided for orders to be executed immediately, orders to be executed in the future (in date order), and orders to be executed by instalments (also in in date order).

When a customer attends personally to give orders, a special form is employed on which details of the order are made and initialled by the buyer who also makes a note of the order in a memorandum book. If the customer's order affects several departments, details are entered in the memorandum book of each buyer, and the order form is then sent to the administrative staff, by whom copies of the component parts of the order are made for the use of the various departments, and the special order form is placed in the "orders-to-be-executed" file.

The duplicate orders made out by the administrative staff are sent to the departments concerned, accompanied by a copy showing collectively the details of the whole order. The various departments then proceed to collect the goods required, taking care that the goods are of the correct quantity, quality and price. Details of the order are then entered in the buyer's "orders-received-and-executed book", in each case showing the customer's name and address, the quantity and price of the goods, and the date when executed. Finally, the duplicate order is dated and initialled by the buyer or his assistant.

DESPATCH DEPARTMENT

The goods are next taken with a packing slip to the packing section of the despatch department, when they are again checked, and, if found to be correct, the slip is initialled and dated by the packer. In those cases where goods from several departments are contained in one order, the packer will assemble the goods in order that they may be despatched to the customer as one consignment.

In the home trade it is usual for each firm to deal with its own packing and forwarding, since the firm itself should be in the best position to judge the requirements best suited to its own line of goods and to its customers. In the export trade, however, it is common to leave this task to a firm specialising in a particular foreign market, in which case both the packing and despatch are often carried out by the one concern, which also attends to shipping formalities.

As each article is packed, the packer ticks it off on the packing slip, and when all the goods are packed, he forwards the slip to the invoice section of the despatch department and sends the packed goods on to the actual despatch section.

The invoice clerks make out invoices in duplicate or triplicate, preferably the latter as one copy can then be sent to the customer by post, a second to the administrative section, and the third, detailing the quantity of goods, can be sent with the consignment to the customer in the form of a delivery note. The duplicate order is attached to the original order which may then be transferred from the "orders-to-be-executed file" to the "orders executed" file.

In the case of export orders it will frequently be necessary to complete certified customs or consular invoices on the prescribed forms. On these it may be necessary to show, in addition to other details, net and gross weights of the goods and packages and the country of origin.

The despatch clerk enters the particulars of each consignment in a book kept for that purpose, taking special care to see that both the date of despatch and the method of carriage are clearly stated. When the goods have actually been sent, the despatch clerk initials the duplicate order, inserts the date and the method by which the goods have been despatched, and sends the order on to the administrative section.

The accounts department will in due course debit the customer's account with the amount of the invoice, while the corresponding credit will be included in the total of the day's credit sales.

GOODS RETURNED

Many wholesale warehouses make it a practice to accept goods returned, provided they are in good condition and the customer has a valid reason for refusing to accept them.

In such cases, a section of the warehouse should be allotted to the receipt of goods returned, and each case should be treated on its merits. The goods should be examined to see that they are in good condition and that they are the identical goods that were despatched from the warehouse. The amount claimed by the customer on account of the return should be checked with the copy of the invoice sent to him and with the amount debited to his account. If no invoice or entry relating to the goods can be traced, inquiries should be made immediately of the buyer of the department concerned (who should have particulars entered in his orders-received-and-executed book) and of the administrative section (where an entry should be found in the sales books). If all is in order and the goods are fit for re-sale, they must be returned to the buying department concerned and full particulars sent to the administrative staff which will pass on instructions to the accounts department. The buying department will pass the returns into stock, making a note in the orders-received-and-executed book and on the stock cards. The accounts department will make out a credit note in duplicate, the original being sent to the customer and the duplicate used for entering particulars in the returns inwards book, whence a transfer will be made crediting the customer's account in due course.

Where goods are returned because they are not in accordance with the customer's order, efforts should be made to trace the cause of the mistake and the customer should be sent a written apology for the error and the delay. The goods may then be taken into stock and, provided the customer has not cancelled the order, other goods conforming with his instructions assembled, under the same procedure as the original order, and despatched by return. It is preferable to give the customer a credit note and to charge the new goods out in the ordinary way rather than to alter the particulars in the various forms and books of account. A similar procedure applies in the case of damaged goods, except that the goods are not, of course, returned to the ordinary stock.

COMPUTERISED EXECUTION OF ORDERS

The procedures described above lend themselves with relative ease to computerised techniques. In a number of wholesale organisations a computer installation is programmed to receive and acknowledge retailers' orders and to transmit those orders by screen display to an operational unit which arranges for their despatch. Despatch notes, invoices and discount particulars are recorded by the computer which, in accordance with its program, then updates retailers' records and warehouse stock files.

CHAPTER TWENTY-FOUR

The Retail Trade—1: Types of Retail Outlet

In the system formed by the flow of goods along channels of distribution, the retail outlet forms the final link in the chain leading from manufacturer to ultimate consumer; it is, effectively, the "supply-demand interface". It is at this point in the system—the shop—where goods, exchanged for money, pass from retailer to customer, that the purpose of production in the market economy is finally achieved.

Retail outlets in an economy characterised by competition differ from one another in a variety of ways, *e.g.*, size, organisation, selling arrangements, type and variety of merchandise carried. These matters emerge in the review given in this chapter of the types of outlet enumerated on pages 295–6, based on the *character* of the outlet.

THE INDEPENDENT STORES

The "corner shop", providing a personal, informal service, the specialised jewellery shop offering expertise of a high order, controlled and staffed by its proprietor and an assistant or two, the small chain group of four or five branches trading at convenient points in shopping centres on small housing estates, exemplify the independent stores which, in 1977, formed almost 80 per cent of the U.K.'s retail outlets, with 42 per cent of the total market. (The comparative figures for the United States were 65 and 40 per cent.) The Census of Distribution defines the independent store as a retail organisation with less than ten branches. The independent retail sector has for long attracted the small-scale, individual entrepreneur; of this sector it has been said, "... the qualifications for membership are minimal and one goes into business simply by 'opening the door', but while the initiation fees are deceptively low, the attending risks of failure are high." As a result of increasing competition, from the multiples in particular, the independent stores have been giving ground in recent years.

Advantages of the independent store stem from site convenience, personal interest of the owner in store operations and the maintenance of customer goodwill, flexibility of opening hours and the general rapport with customers which results from informality in trading arrangements.

Disadvantages stem from lack of capital, specialist expertise and, in

many cases, an inability to change operations so as to conform to altered shopping habits. The onerous clerical tasks which now include the preparation of V.A.T. returns often present severe administrative difficulties for the small trader. (A recent estimate which suggested that as many as 10,000 small food shops do not make any significant profits for their owners, implied that problems of administration were responsible in large measure.)

In the past fifteen years the general decline in the fortunes of the independents has been halted by the formation of voluntary trading groups (23 in 1978) such as the VG and Spar grocery organisations, which allow groups of small retailers to operate with a unified wholesale organisation which deals in standardised, branded products while allowing retailers to maintain their individual, independent status. Many small retailers have increased their sales as the result of the planned programme of promotional offers and point-of-sale advertising material designed by the voluntary groups; selling space has been used more productively as the result of expert guidance from the groups' professional, specialist advisers; stock selections have been improved and shops have been made more attractive and efficient as a result of the groups' merchandising advice and support. Cash and carry warehouses, dealing with the retail trade only, have proliferated in recent years, passing on to the independent traders savings resulting from bulk-buying discounts.

The future of the independent retailer in the U.K. is by no means assured. On the one hand it is difficult to foresee the total disappearance of the small neighbourhood store which, in many areas, is a vital and integral part of the community. On the other hand, spiralling rents, rising labour costs and a continuing intensification of competition from the large-scale retail stores are bound to result in increasing pressure on margins. It is, perhaps, in the further exploitation of the independent retailer's few competitive advantages, such as the provision of a personal service, that his future may rest.

THE MULTIPLES

Stores of this type are defined as "retail firms which own and operate ten or more branches selling a similar type of merchandise". They are exemplified by organisations such as Boots, Burtons and the large variety chains, such as British Home Stores, Littlewoods, Marks and Spencer and Woolworth, the latter with over 1,000 branches. In 1977, 14 per cent of shops in the U.K. were branches of multiple organisations, responsible for 40 per cent of total retail sales.

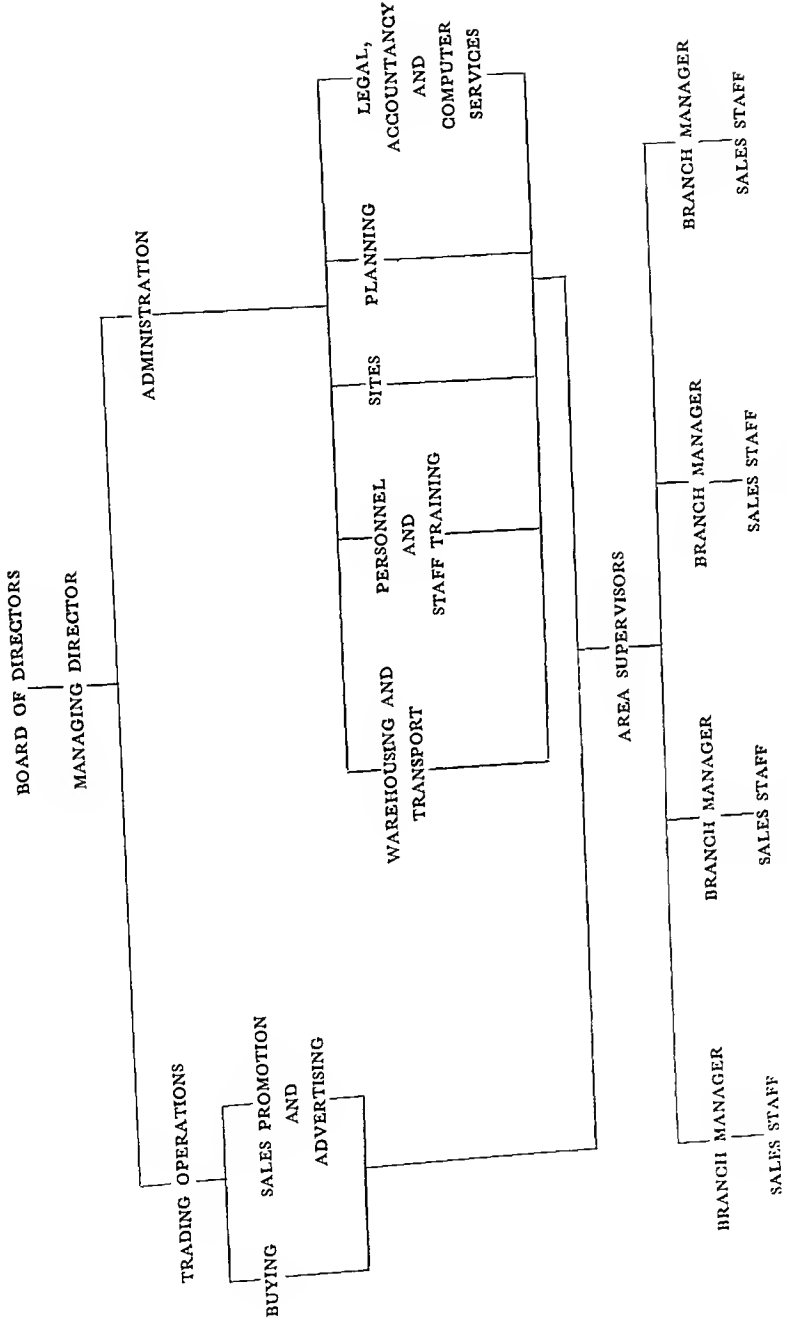
The multiple type of retail outlet developed in this country from patterns set by Singers (who operated over 150 shops in the 1870s),

W. H. Smith and the Home and Colonial Tea Company, for example. The Boots Pure Drug Company opened its first store in 1888, one year later than the first "penny bazaar" operated by Tom Spencer. In the inter-war period the multiples expanded their sales in household goods and clothing in stores which tended to be concentrated in the North of England. Today the multiples include some of the most profitable organisations in the distributive trades and occupy prime nodal positions in the central shopping areas of the country. Some have ventured, with varying degrees of success, into the continental shopping areas of the E.E.C.

The multiples are characterised by centralised buying and decentralised selling, *i.e.*, the buying is sharply separated from the selling, so that a central buying office may be responsible for buying merchandise for the entire group, while the selling function is the responsibility of local branch managers operating under the general control of district supervisors or local inspectors. Ranges of merchandise tend to be restricted to fast-selling lines, with sales floor space planned on the basis of "proportional footage", *i.e.*, the larger the volume of a line sold, the greater the footage it receives. Centralised stock control, often utilising electronic data processing, bulk-buying, standardised administration and displays and expert general advertising, based on control from a head office, lead to a fast rate of stock turn and to the general economies of large-scale enterprise.

The advantages of the multiple store retailing operation are considerable. Thus, for example, standardised procedures lead not only to the advantages stated above, but also to economies resulting from the capacity to remedy shortages of stock at any one branch by transfers from another. Staff interchange and standardised training procedures are also advantageous. The many branches of a multiple organisation are able to cater efficiently for large numbers of customers at a comparatively short distance from their homes. Cash transactions in the stores and a general absence of credit and delivery facilities eliminate a number of problems, such as delivery charge collections and bad debts. The policy of cash refunds where goods are less than satisfactory builds customer goodwill. A centralised administration is able to employ the specialist services of experts in site location, buying and designing. The use of automated warehouses results in economies in delivery to branches. Finally—and of much importance—losses at some branches can be absorbed by others.

There are, however, disadvantages in this type of retailing. For example, it is said that centralised control from head office tends to remove scope for initiative from branch managers to meet local, specialised conditions. Lack of credit and delivery facilities may lose



An example of a Multiple Store Organisation

customers and the lack of the personal touch, associated with the small independents, may repel customers. Finally, costs of storage of merchandise and distribution to branches can be very heavy.

The multiples continue to expand, particularly at the expense of the small, independent trader. In general, they are least successful where demand for goods is narrow and widely-fluctuating and where customers expect a personal service; they are most successful where a restricted range of fast-selling items is in heavy demand. Above all, the benefits of centralised control are highly significant, so that one branch of a multiple becomes an advertisement for other branches. It has been said of this type of outlet: "As long as the goods sold are of good quality in relation to their price, there seems to be no limit to the number of branches which a highly organised and efficient concern may control."

A chart showing a typical multiple retail organisation is given on page 319.

THE DEPARTMENT STORES

A department store may be defined as a store having 25 or more persons engaged in selling in a number of separate departments a wide range of commodities, notably clothing and household goods. The 800 departmental stores in the U.K. include such world-famous names as Selfridges, Harrods and John Lewis. In 1977, department stores took about 6 per cent of the total retail trade. Four groups (Debenhams, John Lewis Partnership, House of Fraser and Sears Holdings) control about half of the country's department stores.

The department store originated in France with the founding of *Bon Marché* in 1852 by Aristide Boucicaut. Although his merchandise assortment was similar to that of many competing stores, he was responsible for a number of innovations in selling: merchandise was sold at a small markup, smaller gross margins being compensated by higher sales volume and increased stock turn; merchandise was offered at fixed, marked prices; entrance to the store was free and there was no pressure on anyone to buy; customers were given the right to exchange merchandise or have money refunds. The success of this and similar department stores was said to be that "their founders understood that, to a new social system whose needs and habits were changing, it was necessary to offer, on the best possible terms, means of satisfying tastes for elegance and comfort unknown to previous generations" (G. Michel).

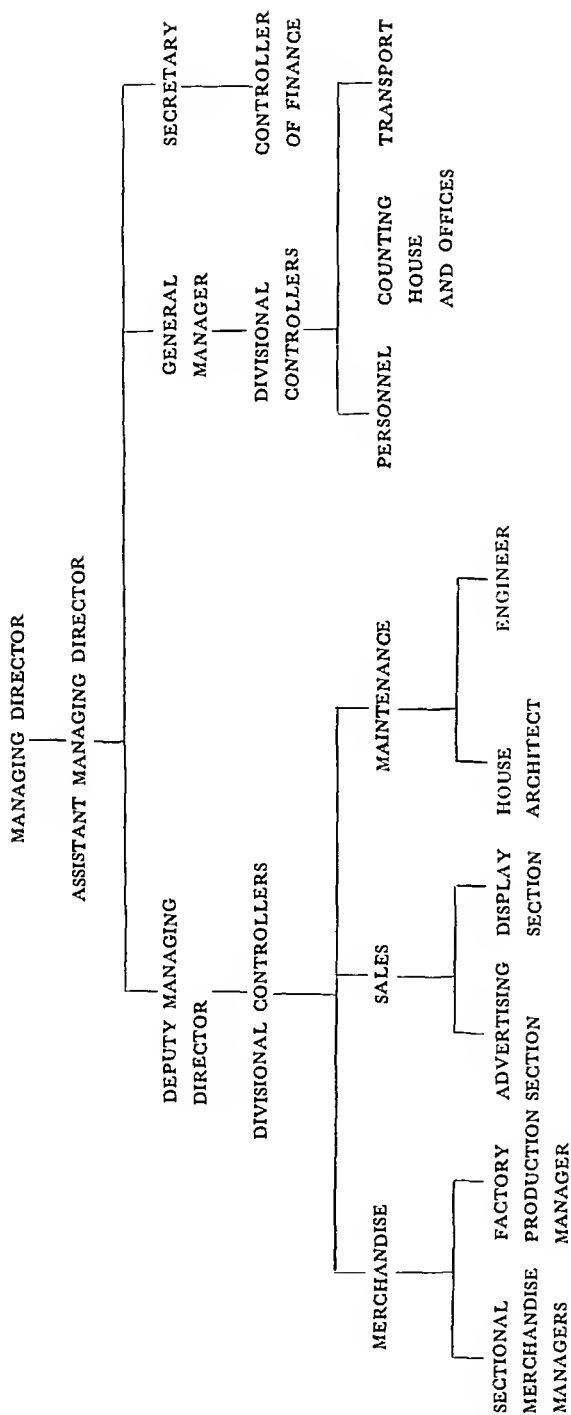
Growth of the department store in this country, which was based on early patterns set by William Whitely and Harrods, for example, reflected the rise in middle class income levels, an increased

availability of different types of merchandise from a variety of sources and the growth of urban concentrations of population. The department store, carrying a wide selection of merchandise in premises which are often set out in lavish manner, has become an imposing and familiar landmark in many towns, in which its very presence acts as a principal "shopping magnet" for the area in which it is located.

The essential feature of department store trading is the offering under one roof of a complete range of services, so that the customer is able, in one shopping expedition, to view a large selection of goods and to utilise a number of additional services, such as tourist offices, hairdressing parlours, etc. Each department in the store is virtually a complete shop in itself and is able to specialise. Risks can be spread over all the merchandise and—as always in this type of retail operation—large-scale, creative merchandising is possible. Each department in the store advertises the others and customer goodwill is increased.

The advantages of department store retailing are implicit in what was said in the paragraph above. Additionally, there is the advantage derived from trading in a central site. Further, the advantages of division of labour are available; specialist staff can be employed in merchandising, display, advertising and training. Standards of service are usually good and special promotions on a large scale attract customers. The many services available, *e.g.*, delivery fleets and theatre booking facilities, also attract customers. An added attraction is the availability of credit facilities (*e.g.*, *budget accounts* involving monthly sums paid by the customer, *charge accounts* involving periodic invoicing and *extended credit* based on interest-free credit allowed on selected merchandise). In recent years, the process of leasing departments in return for a rent, whereby "shops within the store" are operated by the lessees, has resulted in a further extension of merchandise sold by specialised sales staff.

The department store has been criticised on a number of grounds. The very elaborate surroundings and amenities which have come to be expected by its customers have increased overhead expenses so that unit costs have risen sharply. Further, overheads such as rent and rates are often much higher than those of competing businesses operating away from the central shopping areas. The large proportion of non-selling space to total shop area in many department stores has been criticised as wasteful in terms of return to invested capital. Lack of parking facilities, exacerbated by the heavy traffic associated with central shopping areas, has affected department store trade. Finally, the deterioration of some urban centres in which the stores were built and population shifts may have been reflected in trading figures.



Day-to-day management of the store is controlled by the management committee, the chairman of which is either the managing director or the assistant managing director. The members of the committee are the controllers of the seven divisions mentioned above, namely merchandise, sales, maintenance, personnel, counting house and offices, transport and finance.

Organisation of a typical department store

Recent decades have seen what is interpreted as a decline in the importance of those competitive advantages which led to the founding and growth of the department store. Central locations, free deliveries, extensive buildings—the very characteristics of the department store which symbolised its unique nature—have become the very factors responsible in part for transforming the store into a high cost retail outlet. Department stores have responded to this situation in a variety of ways: programmes of alteration and redecoration have transformed some sites; attractive house styles and the presentation of an extended range of “own-label” merchandise have stimulated demand; the development of staff training programmes and management expertise have contributed to higher productivity.

A diagram showing the organisation of a department store is given on page 322.

THE CO-OPERATIVE STORES

The essence of co-operative trading philosophy is mentioned on page 12. From the opening of the first store in Rochdale in 1844, co-operative retailing has spread rapidly. Today, over 7 per cent of the country's retail trade is carried out by over 200 co-operative societies (with 10·7 million members in 1977). Co-operative retail trade, based on 11,700 shops employing 135,000 staff, amounted to £2,400 million in 1977. The largest retail society, Co-operative Retail Services, has over 1·5 million members and annual sales of £360 million. The London Society has over one million members and annual sales of £160 million. Almost 80 per cent of the Movement's sales stem from 50 of its societies.

Over 70 per cent of the Movement's sales is in foodstuffs; 20 per cent is accounted for by “dry goods” (*i.e.*, clothing, other textiles, footwear and furnishings); 10 per cent by solid fuel, chemists' goods, etc. Over one-third of the milk retailed in the U.K. is sold by the Movement.

Membership of a society is open to anyone on payment of a few pence towards a share. Societies are governed by boards of directors elected from the membership. Democratic control reflects the concept of one person, one vote. Dividends are based on purchases, not share-holding. Most societies now use the National Dividends Stamp Scheme, operated by the C.W.S. Stamps are given to customers in proportion to their purchases; full books of stamps may be redeemed for cash, exchanged for goods or placed as a deposit in a share account. It is estimated that, since 1844, almost £2,000 million has been returned to members of the societies in the form of dividends.

The Co-operative Movement's retail outlets generally enjoy the advantages of the techniques of mass distribution, resulting from large capital resources, bulk-buying, automated warehouses, etc. The corporate identity of the movement and the involvement of many members in its direction are said to create customer loyalty of unusual dimensions.

The Movement has suffered, however, from certain disadvantages. The system of control of societies has been said to induce an unwillingness to take risks, to close inefficient branches and to abandon unprofitable selling lines. Further, the influence of the dividend on customers may have diminished in recent years, so that it no longer constitutes a competitive advantage over the privately-owned store.

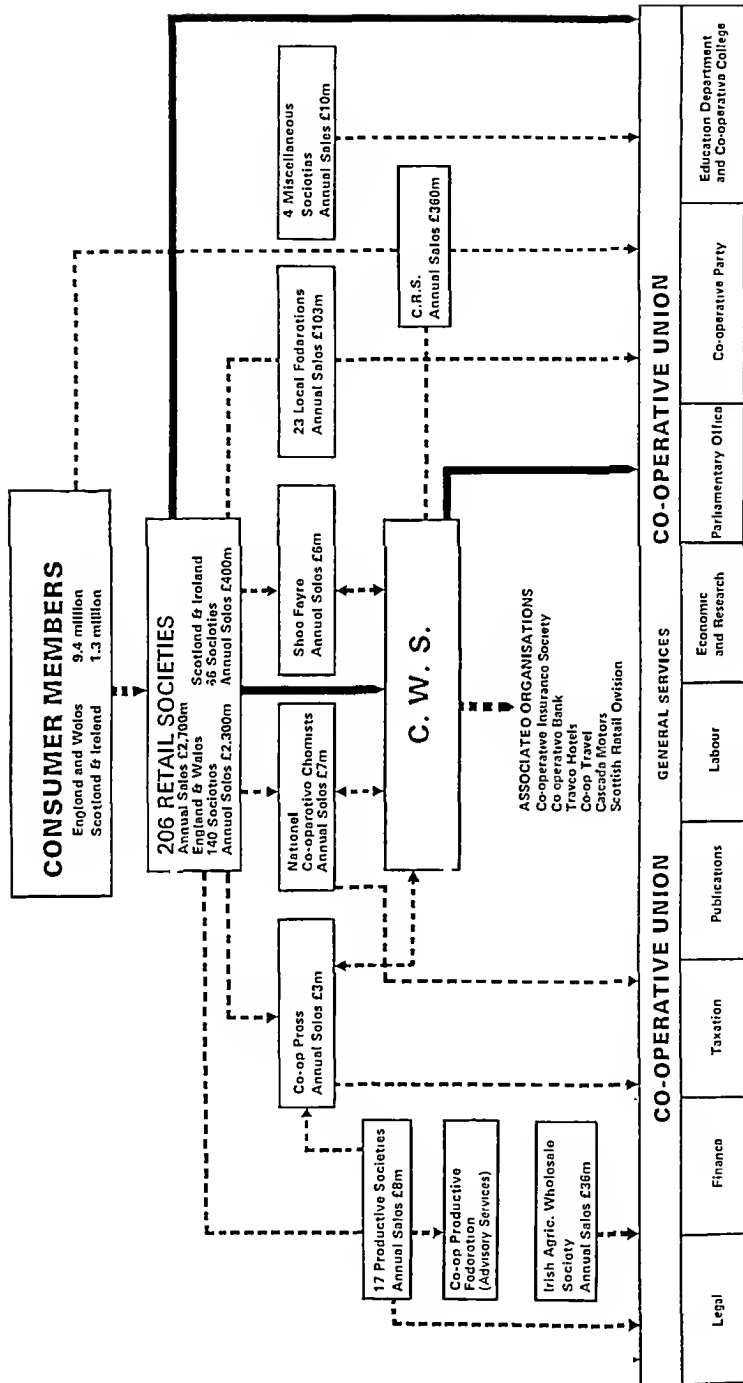
In recent years the fortunes of the Movement have varied. The decline in market share which characterised the 1950s, the liquidity crisis of the late 1960s, have been met by a reorganisation of internal management structures, an increase in the number of mergers and an extension of trading operations so that, in the 1970s, trade has revived. The Movement is able to draw on considerable reserves of customer loyalty and its innovating spirit (which was responsible for the first employment of self-service techniques in a supermarket in Britain and the development of multiple stores) is impressive. It remains an organisation of vast potential.

The structure of the Co-operative Movement is shown in the chart on page 325.

THE SUPERMARKETS

A supermarket is defined as a self-service retail outlet with a minimum selling area of 4,000 square feet (372 square metres), having three or more check-out points and offering a full range of foodstuffs and household requisities. Its operational methods are based on: high turnover of low unit value merchandise at low prices; mass displays of goods with importance attached to impulse-buying; wide range of brands; store lay-out facilitating rapid movement of customers; check-out areas acting as focal points within the store.

The supermarket originated in the United States; the first British supermarket was opened in Edgware by the Co-operative Movement in 1953. Its rapid spread is said to have reflected the existence of a number of social, economic and technological developments of the 1950s: the repeal of resale price maintenance, which led to a fall in retail prices; full employment, which led to staff shortages, giving an impetus to the development of self-service techniques; the growth in the number of working wives who had



Structure of the Co-operative Movement
 (as at January 1978)

Source: C.W.S.

(Bold lines show the direct control of the Co-operative Union by retail societies and the C.W.S., also the direct control of the Wholesale Society by retail societies. Dotted lines show the composition of various bodies and indicate how control is ultimately in the hands of the retail societies, representing their members.)

little time for shopping and who preferred the "one-stop" shop; the use of new techniques of selling involving refrigerated selling units, new packaging materials and electronic cash registers.

Today, Britain's 5,000 supermarkets account for 45 per cent of all retail grocery sales. They are often located in the main shopping centres and the range of goods offered has widened so as to include, *e.g.*, chinaware and clothing in addition to foodstuffs; the result is the conversion of many supermarkets into wide-range outlets catering for large numbers of customers.

Advantages of supermarket retailing include speed and convenience for customers and selective price-cutting which has increased effective demand. Further, the relatively low proportion of labour costs to other operating costs in the supermarket has resulted in a lower level of overall costs, the benefits of which have often been passed on to the customer in the form of selective price reductions.

Disadvantages include the formidable problem of security in the store. Additionally, there is the difficulty generated by the check-out point which, if manned inefficiently, can hold up customer flow. Attempts have been made to solve this problem by the use of queuing theory, but with few dramatic results.

The supermarket is now established as an important retail outlet and its selling techniques have spread to other types of store. Supermarkets operated by firms such as Sainsburys, Tesco and Fine Fare are now among the most efficient units in the distributive trades, their operations being characterised by intensive market research, sales of a very wide range of merchandise and attractive displays.

THE HYPERMARKETS

Retail outlets of this type, exemplified by Carrefour, at Caerphilly, are stores with the following characteristics: at least 50,000 square feet (4,654 square metres) of selling space situated on one level only; a very wide range of food products and non-food items; self-service methods with payment made at one point in the store, comprising 15 or more check-out units; free car parking in an area of at least three times the size of the selling area.

There are about 70 stores of this type planned for this country at the present time, in contrast to the 700 operating in the E.E.C. The slow rate of growth may reflect difficulties in obtaining planning permission. A directive from the Department of the Environment applies the following criteria to hypermarket planning permission: there is to be no undue disturbance of existing retail patterns in an area as the result of the opening of a hypermarket; there is to be no

resulting traffic congestion; the chosen site must be environmentally suitable.

The opening of Carrefour in 1973 at Caerphilly (twenty years after the opening of the first hypermarket in France) resulted in a swift reaction from local traders who claimed that they had experienced a 20 per cent fall in sales. Investigations did not entirely bear out this claim, but there is little doubt of the hypermarket's reputation as a threat to the small trader.

Carrefour opened with a selling area of 56,000 square feet (5,203 square metres), 26 check-out points and 290,000 square feet (26,942 square metres) of parking space. Mass merchandising methods were employed in combination with a policy of discounting. Experience in the first years of trading indicated the existence of a pattern of selling based on the majority of sales being made in evening hours and on Saturdays. The operation has been very profitable and has encouraged other firms to seek planning permission for the construction of similar stores.

Advantages of hypermarket retailing turn on the low costs and prices and the convenience of self-service, in addition to the wide range of commodities on offer which characterise "one-stop" shopping. Parking facilities draw customers from a wide shopping area and crowded shopping centres in towns may be relieved by the hypermarket which is usually 2-4 miles from town centres.

Disadvantages attending the operations of hypermarkets include the encroachment of retailing units on green belt areas and an extension of traffic problems near the sites. Some local authorities doubt the wisdom of creating surplus trading capacity which results in declining rate revenues from small traders and a fall in the provision of shopping facilities for non-car owners.

THE SUPERSTORES

These outlets are defined as stores having the following general characteristics: a selling area of at least 20,000-30,000 square feet (1,858-2,787 square metres) on one level; a very wide range of food and non-food products at discounted prices; availability of some self-service facilities; 10-20 check-out points; free car parking facilities of 1-3 times the area of the selling space. There are over 60 such stores in Britain; ASDA's superstores in the North and Midlands are typical examples.

Essential differences between the hypermarket and the superstore are: hypermarkets invariably operate mass merchandising techniques, but this is not always so in the case of superstores; hypermarkets operate self-service techniques with check-outs usually

in one central point, but superstores may use other methods; car parking spaces are calculated on the basis of different ratios.

The advantages and disadvantages of the superstore are generally similar to those of the hypermarket.

THE MAIL ORDER ORGANISATION

Mail order involves selecting merchandise from an illustrated catalogue or leaflet and placing an order by post or through an agent. This type of retailing originated in the United States with Montgomery Ward (1872) and Sears Roebuck (1893), whose customers were mainly rural farmers isolated from trading centres. Today, mail order organisations in the U.K. enjoy 4-5 per cent of the retail market, with an estimated turnover of £1,400 million, representing 8.5 per cent of the country's non-food sales. Catalogue sales between 1970-76 grew by 152 per cent, involving 15 million customers.

Three types of mail order organisation are common: the small firm, specialising in one line, *e.g.*, radio equipment, and advertising in newspaper and specialist periodicals; the department store postal service section; the large-scale warehousing firms which send out catalogues and are served by agents who earn up to 10 per cent commission on sales. This latter category of organisation is dominated by Empire Stores, Freemans, Grattans, Great Universal Stores, Littlewoods and Myers; they take almost 90 per cent of mail order trade.

Not all commodities lend themselves to the mail order operation. Typically, goods to be sold by mail order should be designed and marketed to satisfy a well-defined consumer need; they should lend themselves to pictorial representation in catalogues; they should not require back-up services; they should be suitable for delivery by road or rail. Technically-complicated goods may not always be suitable. The market in the U.K. is based on clothing and footwear (50 per cent) and household goods (30 per cent). Radio and television form an increasing percentage of the total figure.

The advantages of mail order trading include the virtual elimination of salesmen's salaries and shop rents. Sales appeal can be designed by experts and not left to individual sales staff. Large-scale economies resulting from bulk-buying and the use of automated warehouses are made possible and risks can be spread through diversification. Operations within the organisations can be reduced to routine, so that little skill and training are required. Easy credit facilities attract custom and advertising can be carried out effectively, since results can be monitored accurately.

Disadvantages stem from the lack of personal contact with the customer. Further, a stereotyped sales appeal cannot be varied to suit individual tastes. Only a limited range of goods can be sold by this method and very heavy advertising costs are needed to maintain sales. Large stocks must be held and there is always a difficulty on forecasting long-term trends and reacting swiftly to sudden changes in fashion. Finally, road and rail deliveries, on which the success of the operation depends, are not always free from interruption.

The share of mail order firms in the retail market grew rapidly between 1961-66; it slowed down from 1966-71; it is now increasing. Market research to discover the socio-economic characteristics of a firm's customers has been intensified, computer techniques have been applied to problems of stock control and sales promotion has improved—one firm uses a film to describe its mode of operation, another distributes a monthly newspaper to agents and customers, relating to company developments. The factors of convenience associated with mail order selling—no crowded stores, time to make a selection of goods free from sales pressure and no need for a cash payment when the request for goods is made—appear to offer a growing market to those operating in this area of retailing.

THE DISCOUNT STORES

Stores of this kind, typified by firms such as Argos and Comet, are based on the retailing of branded goods well below recommended list prices, minimal customer services and facilities, and self-service techniques.

The discount stores developed in the United States in the late 1930s. In this country they flourished only after the abolition of resale price maintenance in 1964. They can be categorised thus: "open showrooms", maintained by manufacturers or wholesalers, selling to the consumer at less than regular prices; "closed stores", selling only to special customers affiliated to recognised groups below regular prices; "open discount stores", based on high volume, low-markup operations involving nationally-advertised, easily identifiable branded goods that enjoy wide acceptance; "discount department stores" in which a wide variety of merchandise is displayed under one roof and retailed in semi-supermarket style (the Woolco store at Oadby is an example).

A typical discount store will be based away from the central shopping centres, often in a relatively low-rented area, served by a large car park. Branded durables will be offered, generally on a cash basis, at 10-25 per cent below regular retail prices in surroundings in which amenities may be few. The goods may be selected by reference

to a catalogue and to samples. They will be passed to the customer, often in manufacturers' cartons, and carried away by him.

Advantages of this form of retail include the benefits of low overhead costs and maximum turnover from minimum capital outlay, which can be passed on to the customer in the form of reduced prices. National advertising added to strong price appeal can increase demand, and self-service minimises delivery delays associated with some types of merchandise.

Disadvantages arise from the absence of amenities for customers. Further, choice is limited where consumers may select from only a limited group of fast-selling lines.

The recent development of discount trading has changed the style of selling associated with the earlier stores. Spartan, undecorated premises and goods displayed on trestle tables have given way to carpeted selling areas, carefully-designed display units, trolleys in which goods can be carried to customers' cars; in some cases, credit facilities and delivery facilities are now available. Advocates of this type of retailing point to the rapid growth in the types of merchandise now on offer in discount stores; the initial concentration on electrical appliances and hardware has given way to include a wider selection including food, textiles, furniture and decorating supplies. They argue that the discount store will continue to flourish as customers become aware of having to pay in the traditional shops for services they do not want. The discount stores are now facing growing competition from the hypermarket and the superstore; some have responded to the challenge by increasing amenities, *e.g.*, cafeterias, car-service centres and complete credit services.

OTHER FORMS OF RETAILING

"Non-store" types of retailing include the following:

- (a) *Mobile shops and market stalls.* There are an estimated 32,000 mobile shops and market traders' stalls, employing around 38,000 people. The mobile shops are concerned mainly with sales of food: two-fifths specialise in groceries; one-fifth specialise in meat; the remainder deal in hardware, paraffin, etc. Co-operative societies control a large number of mobile shops serving housing estates and suburbs.
- (b) *Automatic vending machines.* There are now over half a million automatic selling machines in operation in the U.K., offering—at all times of day and night—cigarettes, confectionery, drinks, prepared foodstuffs, stamps, etc.
- (c) *Kiosks.* These small outlets offer a very limited range of cheap consumer lines such as cigarettes and sweets, newspapers and

magazines. They tend to be sited where customer flow is heavy, *e.g.*, in or near railway stations where impulse buying is likely to be common.

- (d) *Home-selling*. This retail activity involves visits by agents to homes in which selling results from a selection made by perusing catalogues and other promotional material. An example of this type of operation is that carried on by the Avon organisation which offers about 800 products through a network of 100,000 part-time representatives. Personal service characterises this form of retailing.

CHAPTER TWENTY-FIVE

The Retail Trade—II: Retailing Operations and Consumer Legislation

Retailing operations have as their aims, on the one hand, the satisfaction of consumer demand and the maximisation of customer goodwill and, on the other hand, the optimisation of return on the retailer's investment. In pursuit of these aims the retailer exploits the *differential advantages* available to him; these advantages derive from, e.g., store location, store lay-out, buying acumen, pricing.

STORE LOCATION

Where the retailer is presented with the choice of a number of alternative trading locations he will be guided in that choice by overall factors such as the *nature of his trading operation* (a discount store and a small branch of a supermarket chain will not necessarily require the same type of site), the *costs* involved and the *trading potential* of the site. Location of the selling unit is a major influence on the level of retail profits and long-term chances of success; it requires, before site decisions are taken, a careful analysis which may begin with a consideration of "area" problems.

CATCHMENT, SHOPPING AND DEVELOPMENT AREAS

A "catchment area" is the *geographical area from which a shopping area* (see below) *tends to draw its customers*. Its structure and potential may be estimated by an examination of factors such as: population and age-structure; strength of retail competition in the area; accessibility, i.e., travel facilities and parking space.

The "shopping area" is the *area from which an individual store tends to draw its customers*. The determinants of a shopping area's potential include local levels of employment, purchasing power, competition, traffic flows, etc.

The "development area" concept is based on *general possibilities of growth apparent in a geographical area*, e.g., expected population patterns and purchasing power, general employment prospects, planning and other legal regulations affecting the growth of trade, prospects of availability of an adequate labour force and long-term changes in the pattern and intensity of competition.

A recent survey has suggested figures for minimum "trade support populations" necessary if a new entrant into a trading area is to

succeed; they indicate: for a grocery store, 750–1,000; butcher, 2–3,000; chemist and newsagent, 4–5,000; fishmonger, 5–12,000; medium-sized supermarket, 20,000.

THE "SATURATION INDEX"

A firm choosing a site in an area may be guided by a consideration of the existing level of competing retail facilities within that area so that it can avoid entering a district which is "saturated". Store saturation has been described as "a condition under which existing store facilities are utilised efficiently and consumers' needs are met adequately". Where the firm choosing a site has nothing to offer which will differentiate it from existing firms, *i.e.*, where it has no differential advantage which it can exploit, there is no gain to be derived from its setting up on that site.

A measure of area store saturation is given by the *index of saturation* (I), based on the number of consumers in the trade area (C), the average current expenditure on the type of goods to be retailed by the newcomer within that area (E) and competing retail facilities in the area measured, *e.g.*, in terms of selling space (F). Given these factors, then $I = \frac{CE}{F}$. The index can be used to suggest the "break-even point" below which a new entrant to the retail area cannot trade effectively.

SITE SELECTION IN PRACTICE

A large retail organisation will generally take into account the following specific matters when considering a possible site in an area which appears to offer possibilities for effective trading operations:

- (1) *General statistical data for the area, e.g.*, actual and projected population figures and trends, local family expenditure, average family size, employment levels, housing plans and pedestrian traffic flows.
- (2) *Location of the site in relation to the wider geographical market.*
- (3) *Competition, actual and potential, e.g.*, existing shops selling similar lines, plans for future shopping development in the area, size of existing retail labour force, ratio of existing multiples to independent stores.
- (4) *Potential of site, e.g.*, planned growth of transport and parking facilities, plans for development of adjoining areas, possible emergence of detrimental environmental characteristics, such as the deterioration of buildings in the area.
- (5) *Finally: "Is this an area in which we ought to trade, given our*

image and our long-term plans?" An affirmative answer is required if the proposed site is to be considered further.

MERCHANDISING OPERATIONS

Retailers, no matter what the type or size of their stores, have the same fundamental operational tasks—deciding on lay-out, buying appropriate merchandise, controlling and protecting the stock of merchandise, calculating selling prices for individual items of stock, maintaining or improving rates of stock turnover, providing an appropriate level of after-sales service and observing the provisions of statutes relating to consumer protection.

STORE LAY-OUT

The retailer's decisions on the lay-out of his store will be of much importance for the overall success of his general merchandising operations. "Lay-out" refers to the methodical and planned arrangement of the material components of his store so as to achieve maximum productivity. His objective will be the arrangement and utilisation of space (vertical and horizontal), fixtures and stock so that customers, sales staff and merchandise are combined in the selling operation as efficiently as possible. Attainment of this objective will generally necessitate the store's appearance being attractive and inviting. Display of stock, point-of-sale advertising and general advertising material are of importance; posters and similar visual displays ought to be attractive, informative and persuasive.

Lay-out will be governed primarily by the size and shape of the building and the shopping area within, the number of floors, location of entrances and exits, staircases, lifts, loading and service areas, type of merchandise, type of trading (*e.g.*, self-service), projected customer-flow, etc.

In variety chain stores, lay-out will generally take into account the "clear-view" plan, allowing customers to see most selling sections of a shopping area at a glance. In a lay-out of this nature, "reduced areas", *i.e.*, sections of the store selling marked-down goods, will tend to be placed in the centre of the shopping area, often alongside cash registers.

In the supermarkets, lay-out is often governed by observance of the principle "unseen is unsold", *i.e.*, display of goods is vital. It has been estimated that almost 75 per cent of buying decisions relating to supermarket merchandise are made within the supermarket itself, so that lay-out and display are highly important. Most supermarket customers apparently tend to move, on entry, to the right-hand side

of the store and prefer to walk parallel to the walls rather than move immediately to the store centre; hence, the lay-out and positioning of goods along these walls requires careful attention. Produce sections are often sited against walls close to entrances. The so-called "ring of perishables", *i.e.*, the selling units containing perishable foods constitute a common feature of many supermarket outer-wall lay-out arrangements. The siting of meat-selling areas against rear walls—often because of proximity to cutting and refrigeration rooms—is another characteristic feature of supermarket lay-out.

The department store, because of customer-flow and the large number of items carried, lays emphasis on aisles of adequate width, grouped merchandise, a minimum of "dead space" (*i.e.*, areas in which no actual selling takes place) etc. These factors tend to govern the arrangement of store fixtures and the utilisation of space.

In most types of store attention is paid to the display of goods related to "impulse buying". Impulse items are those products purchased by consumers although they may not be needed, *i.e.*, they are bought without any pre-planning. They generally have some of the following characteristics: they are low-priced; they have a short life, *i.e.*, they are used up swiftly and bought frequently; they are small and lightweight; they can be carried and stored without difficulty; they are not necessities. Some retailers classify impulse buying under three headings: *pure impulse buying*, *i.e.*, where the consumer is attracted by the novelty of the product; *reminder impulse buying*, *i.e.*, where a consumer sees the item and is reminded that he is out of stock; *suggestion impulse buying*, *i.e.*, where, on seeing a product, a consumer perceives a need for it. Store lay-out will take into account the importance of impulse buying; siting of commodities throughout a self-service store and, in particular, near check-out point and aisle intersections, has to be planned so as to elicit appropriate consumer response.

BUYING

The retail buying function involves all those procedures related to the actual selection, purchasing and pricing of goods in conformity to the general trading policies of the store. Specifically, the store buyer is concerned with answers to the following questions:

- (a) *What should be bought?* Customer needs, actual and potential, seasonal demands, store image, competition from neighbouring stores, will determine the answer.
- (b) *How much should be bought?* Effective demand, prevailing fashions, available purchasing budget must be taken into account.

- (c) *From whom should merchandise be bought?* Existing distribution channels, costs, estimated times of delivery must be examined in deciding whether to purchase direct from a manufacturer, wholesaler or other agent.
- (d) *When should the merchandise be bought?* The nature and importance of seasonal demand, the purchasing programme necessary for goods to appear at the desired time in the store, type of merchandise, will affect the buyer's answer.

The retail buyer must have a detailed knowledge of many types of merchandise; additionally, he should be capable of analysing and appraising customer characteristics, identifying tastes and trends, differentiating the temporary whim and the long-term change in fashion, locating and evaluating alternative sources of supply. He must base his buying strategy on the demands of three plans: the store's "range plan", *i.e.*, store policy in relation to classification of lines to be carried and price levels; the store's "buying plan", *i.e.*, store policy in relation to trading patterns; the store's "trading plan", *i.e.*, store policy relating to levels of profit, acceptable margins, turnover rate, etc.

A growing number of the larger stores and groups operate a system of *centralised buying* under which buying procedures are concentrated in the hands of specialist buyers operating in a central buying unit where merchandise is selected and orders are placed in bulk for the entire store or group.

The *advantages* of central buying are said to include the following: better terms may be obtained from suppliers as the result of placing large orders; full-time, specialist buyers can be employed who, because they are continuously in touch with the market, can interpret and react swiftly to changes in demand; merchandise can be transferred from one department or store to another so as to meet variations in demand.

The *disadvantages* of central buying are said to include: local and specialised shopping needs may be ignored or misinterpreted; warehousing and distribution costs may increase; important merchandise information may not reach local selling departments; stock replenishment times may increase; uniformity of merchandise and standard presentation throughout a group's individual stores may dampen consumer response.

MERCHANDISE MANAGEMENT

Under this general heading are those matters relating to the *control* of the merchandise. Stock holding and "stockturn" must be regulated so as to maintain or improve the return on invested capital. The best

“merchandise mix”, i.e., the assortment of goods appropriate to the retailer’s “market segment” (the specific group he wishes to serve), must be established. Stock must be protected. After-sales service must be considered. In general terms an optimum relationship between stock investment and levels of service offered to the customer must be discovered and maintained.

The goals of merchandise management have been defined as: meeting immediate customer demands satisfactorily; improving profit levels; optimising the return on inventory; minimising the amount of slow-selling stock carried; improving stock assortment, thus permitting more effective selling; providing maximum consumer satisfaction, confidence and goodwill.

PRICING

The use of techniques of retail pricing will reflect the retailer’s response to his chosen “market segment”, the character and image of his store, profit expectations, competition and long-term development plans. Sound pricing decisions are essential if the cost of merchandise is to be covered, expenses are to be paid, profit margins are to be adequate and customer’s goodwill is to be maintained.

Markup pricing is based on the concept of markup (MU), i.e., the difference between the cost of an item and its retail price (R). In general, it is expressed as a percentage of retail price, thus:

$$\text{MU}\% = \frac{\text{MU}}{\text{R}}$$
 Selling prices for individual items of merchandise are calculated by dividing known cost (C) by 1 minus markup percentage, thus:
$$\text{R} = \frac{\text{C}}{1 - \text{MU}\%}$$

Price lining refers to the technique of selling merchandise at a limited number of pre-determined “popular” prices. The usual pricing routine is reversed and the store buyer begins by considering a retail price “slot” and then searching for merchandise that can be sold in that “slot”. Thus, men’s ties may be sold by a store on the basis of three pre-planned “price points”, e.g., £1.50, £2.00 and £2.75.

Customary pricing refers to the preference of some retailers for certain “price endings”, based on so-called “psychological” pricing, so that a commodity is sold at, say, £5.99 or £9.95. This technique tends to follow tradition and habit; there would seem to be little intuitive understanding of customer habits or scientific analysis of consumer motivation evident in the procedure.

Markdown pricing is based on reductions in retail prices intended to increase the movement of slow-selling merchandise. A markdown price has been defined as “the minimum amount necessary to move

the merchandise". Price reductions of this nature may follow on poor buying programmes, late deliveries, inadequate sales promotion, unexpected changes in market conditions and merchandise perishability.

Scarcity-value pricing refers to pricing based on response to the consumer's subjective valuation of goods. Thus: "convenience goods" are those bought with a minimum of searching, *e.g.*, everyday, plentiful foods; "shopping goods" (known also as "comparison goods") are those bought after a search, *e.g.*, foods not usually stocked by a large supermarket; "specialty goods" are those which cannot be purchased without a considerable search, *e.g.*, rare, imported food-stuffs stocked by a few small stores only. The first type of goods will command a relatively low price; the second type will be more expensive; the third type will carry the high markup price associated with luxury goods.

The effective use of *loss-leaders*, *i.e.*, items priced below cost and used as "customer-traffic generators and builders", depends on an awareness by the retailer of the following matters: the goods must be well-known and widely used; they must be low-priced demand for for the goods must be highly-elastic, *i.e.*, responsive to small variations in price; the goods should not compete with other normally-priced similar items in the store.

In general, retail pricing is determined basically by the influence and interaction of two sets of factors, external and internal:

- (a) *External factors* include: legal considerations, *e.g.*, price controls; elasticities of demand and supply; competition (local, area and national); manufacturers' recommended prices.
- (b) *Internal factors* include: cost of the merchandise; type of merchandise; company and store image and trading policy; judgments of the appeal of merchandise made by the store's buying staff; desired rate of stockturn.

STOCKTURN AND OTHER MEASURES OF THE RETAILER'S PERFORMANCE

Stockturn (or "stock turnover") is a measure of the frequency with which merchandise is bought and sold, *i.e.*, the number of times average stock is sold and replaced in a period of time, usually a year. It is calculated by dividing sales by average stocks. An increase in stockturn generally results in improved return on investment and is, therefore, a measure of sound performance.

Variations in the rate of stockturn may reflect: the type of product on sale; proximity and success of competing stores; site location; sales promotion; selling techniques; general managerial efficiency.

Methods of improving the rate of stockturn may include: the

utilisation of research designed to discover the most profitable lines to be carried; the holding of balanced stocks; experimentation with new lines and novel price levels; reduction in variety of stocks; improvement in accessibility, appearance and advertising of stocks; improvements in techniques of salesmanship; clearance of slow-moving lines by special promotions or reduced prices.

Other measures of retail performance include:

- (a) Net sales volume of a given selling area.
- (b) Gross profit, *i.e.*, sales at selling price less cost of goods to the retailer.
- (c) Net profit, measured by, *e.g.*, fixed assets + current assets — current liabilities.
- (d) Margins, *e.g.*, gross profit as percentage of selling price.
- (e) Capital efficiency, *i.e.*, sales divided by invested capital.
- (f) Average transaction value, *i.e.*, total sales divided by number of transactions.
- (g) Sales per employee.

SECURITY AND LOSS PREVENTION

A recent estimate of U.K. retailers' losses from shrinkage in 1977 was £520 million (about 3 per cent of margins); "shrinkage" in this context is defined as the amount by which the actual physical inventory of a retail outlet falls below the amount which should be there according to the accounts. Most shrinkage results from dishonest practices, *e.g.*, theft ("shoplifting"), cheque and credit card frauds, ticket switching and similar deceptions.

Responsibility for security and loss prevention rests on all sales staff and, ultimately, on store management. Among the measures which can be adopted in the retail store so as to minimise shrinkage are the following:

- (a) The installation and use of effective systems of receiving goods, cash till procedures capable of being monitored, accurate stock taking and careful stock control.
- (b) Training of staff in security procedures.
- (c) Planning by management to reduce the number of "hidden" sales areas.
- (d) Use of trained security officers and electronic surveillance devices.
- (e) Control of all store rooms.
- (f) Restriction of unsupervised displays.
- (g) Use of test purchasing.
- (h) Concentration on prevention rather than detection.

AFTER-SALES SERVICE

The rationale of after-sales service has found expression in the concept of the "total product", comprising the tangible goods sold, *plus* the "extended part of the product", *i.e.*, warranties, services, guarantees. The psychological satisfaction of the customer is essential if sales are to be maintained or improved and this must be built on customer acceptance of the "total product" on offer. The purchaser of a transistor radio, for example, will derive optimum satisfaction not only from the appearance, price and performance of the apparatus, but also from his knowledge of the availability of swift and efficient after-sales repair facilities, etc.

The level of after-sales service to be provided will depend upon: the type and grade of merchandise; the real cost, in the long-run, of providing a skilled staff of repair mechanics, etc.; practice of competitors; legal requirements; the importance attached to customer goodwill; relationship of service costs and profit margins.

CONSUMER LEGISLATION

The ancient maxim, *caveat emptor* (let the buyer beware) is fast losing its importance in relation to retail trading. The buyer is now protected by legislation which has extended his rights and the retailer's duties. Prominent among the mass of consumer law are the following statutes: *Sale of Goods Act 1893*; *Trade Descriptions Act 1968*; *Unsolicited Goods and Services Act 1971*; *Fair Trading Act 1973*; *Consumer Credit Act 1974*; *Unfair Contract Terms Act 1977*.

The *Sale of Goods Act 1893*, as subsequently amended, includes a number of very important provisions directly related to the consumer-retailer relationship; among them are the following:

- (a) A contract of sale is defined as a contract whereby the seller transfers, or agrees to transfer, the property in goods to the buyer in return for a money consideration called the "price".
- (b) In general, a buyer acquires no better title to goods than the seller possessed.
- (c) Conditions and warranties in the contract of sale are clearly distinguished. A *condition* is a stipulation in an agreement which goes to the very root of that contract. Since it is the essence of the contract, a breach of condition allows the contract to be treated as repudiated. A *warranty* is a stipulation which is collateral to the principal purpose of the contract; breach gives rise to a claim for damages, not to a right to treat the contract as repudiated. There are several important conditions and warranties implied by the Act in a contract of

sale, *e.g.*, that the seller has a right to sell the goods; that where there is a sale of goods by sample, the goods shall correspond with the description; that where a seller sells goods in the course of a business, the goods are of merchantable quality. Goods are held to be of "merchantable quality" within the meaning of the 1893 Act "if they are as fit for the purpose or purposes for which goods of that kind are commonly bought as it is reasonable to expect, having regard to any description applied to them, the price (if relevant) and all the other relevant circumstances": *Sale of Goods Act* 1893, s. 62 (1A), added by *Supply of Goods (Implied Terms) Act* 1973.

The *Trade Descriptions Act* 1968 makes it a criminal offence for a retailer to apply a false trade description to any goods or to supply or offer to supply any goods to which a false trade description has been applied. A "trade description" is considered as an indication, direct or indirect, and by whatever means given, of matters relating to: size and quantity; method of manufacture; composition; fitness for purpose; performance; testing and results; place or date of manufacture; other history, etc. It is also an offence for a retailer to give a false indication to the effect that the price at which goods are offered is equal to or less than a recommended price, or the price at which the goods or goods of the same description were previously offered by him.

Under the *Unsolicited Goods and Services Act* 1971, if unsolicited goods, *i.e.*, goods sent to persons who had not asked for them, are delivered for sale or hire they become the property of the recipient as though they were an unconditional gift if the sender does not take them back within six months of their receipt, or earlier if the recipient gives notice to the sender. It is an offence to demand payment for unsolicited goods where the person making the demand has no cause to believe that there is a right to payment: see *Unsolicited Goods and Services (Invoices, etc.) Regulations* 1975.

The *Fair Trading Act* 1973 covers trade practices considered to have an adverse effect on the economic interests of consumers. Such practices may be referred by the Director General of Fair Trading to the Consumer Protection Advisory Committee, and orders may be made for the control or prevention of those practices. An example of such orders is that which prohibits the display of an exemption clause which is void under the *Sale of Goods Act* 1893 as amended by the *Supply of Goods (Implied Terms) Act* 1973.

The *Consumer Credit Act* 1974 has application to most types of credit, *e.g.*, hire-purchase, credit card accounts, given by those engaged in a "consumer credit business". The Act defines "regulated

agreements" and a business involved in these agreements must be licensed by the Office of Fair Trading.

The *Unfair Contract Terms Act 1977* provides that where one party deals "as a consumer" with another party, that other party cannot rely on a contract which excludes or restricts his liability for breach of contract, or allows him to render a performance substantially different from that reasonably expected of him, or allows him to render no performance at all, unless the term in the contract is "reasonable" in the circumstances, *e.g.*, known to the parties at the time the contract was made. A guarantee of goods cannot exclude or restrict liability in respect of defects resulting from negligence in the manufacture or distribution of the goods.

HIRE-PURCHASE

The essence of a hire-purchase contract is an agreement under which goods are delivered to a customer who has agreed that he will make periodic payments of a stated amount by way of hire, with the option of purchasing the goods after he has paid a stated number of hire instalments. In formal terms, under the *Consumer Credit Act 1974* which now governs the hire-purchase transaction between retailer and customer, it means "an agreement, other than a conditional sale agreement, under which (a) goods are bailed or (in Scotland) hired in return for periodical payments by the person to whom they are bailed or hired, and (b) the property in the goods will pass to that person if the terms of the agreement are complied with and one or more of the following occurs—(i) the exercise of an option to purchase by that person, (ii) the doing of any other specified act by any party to the agreement, (iii) the happening of any other specified event": s. 189 (1). (Note that references here are to sections of the 1974 Act.) A "conditional sale agreement" referred to above means an agreement for the sale of goods under which the purchase price or part of it is payable by instalments, and the property in those goods is to remain in the seller until such conditions as to the payment of instalments or otherwise as specified in the agreement are fulfilled.

(a) Under the 1974 Act a hire-purchase agreement is considered as a "regulated consumer credit agreement" if it fulfils two conditions: first, that the hirer is not a company or a body corporate and; secondly, that the amount of credit (*i.e.*, the capital amount borrowed, not the deposit, interest or finance charges) does not exceed £5,000: ss. 8, 9.

(b) Under the 1974 Act the customer is known as the "debtor"; the other party is known as the "creditor".

(c) It is not possible to contract out of the protection provided by the provisions of the 1974 Act.

(d) If the hire-purchase agreement is a "regulated agreement", it must conform with the requirements of the 1974 Act: ss. 55, 60-65. For example: specified information as to the true annual cost of the credit granted must be given in approved fashion to the customer before he enters the agreement; all terms must be embodied in the written agreement; the customer must sign the agreement and must receive a copy when he is given or sent the agreement for signature; where the agreement is not actually made when the customer signs, he must be given a second copy at a later date.

(e) Where the customer signs a hire-purchase agreement away from trade premises he is allowed a "cooling off" period, beginning at the time of his signing and continuing until the end of the fifth clear day after he receives a second copy of the agreements: s. 68. During that period he may cancel the agreement.

(f) A hire-purchase agreement can be terminated in accordance with the terms of that agreement, or it may be broken if the debtor defaults on instalments. Under the 1974 Act, the creditor must, if he wishes to terminate the agreement for some reason other than the debtor's breach, serve written notice giving at least seven days warning. In the case of the debtor's breach, a default notice giving seven days warning must be given: s. 87. The debtor may then pay off his arrears before the expiry date of the default notice, or apply to the court for a "time order", giving him additional time to pay: s. 129. He may also utilise the provisions of the Act relating to "protected goods". Goods are protected goods if the debtor is in breach of the agreement and he has tendered or paid at least one-third of the total hire-purchase price: s. 90. A creditor may not, otherwise than by court action, recover possession of protected goods from a debtor. Should he contravene that rule in recovering possession, the agreement is considered as terminated and the debtor is released from his liability under it; he may also recover sums already paid: s. 91. The creditor can obtain possession of the goods with the debtor's consent and he is allowed to seize possession if the debtor has permanently disposed of the goods to a third party or has abandoned them. Once the agreement has terminated, a creditor may take court action to recover possession of protected goods.

(g) Under a regulated agreement, a debtor has a statutory right of determining the agreement at any time by giving appropriate notice to the creditor. In such a case the debtor must return the goods *and* pay all arrears of instalments due before termination, damages for any loss caused by his failure to take reasonable care of the goods and

the smallest of the three following sums: (i) the amount of the minimum payment stated in the agreement; (ii) the amount necessary to bring his payments to half the total hire-purchase price; (iii) the loss suffered by the creditor as a result of the termination of the agreement.

CHAPTER TWENTY-SIX

Transport and Communication—1: Road and Rail

TRANSPORT AND THE ECONOMY

The importance of transport in the national economy may be illustrated by the following statistics: over 8 per cent of the gross national product is derived from activities under the general heading of transport and communication; 1.4 million persons are currently employed in the transport sector of the economy, almost 6 per cent of the total labour force.

The importance of *Total Distribution Cost* (TDC) in the commercial sector of the economy cannot be stressed too highly. The comparative costs of various modes of transport may be determining factors in the efficiency, in real-cost terms, of the distribution system. TDC has to be estimated in relation to the nature of the goods to be transported, method of local supply, packing required, insurance, customer's wishes and availability of various types of transport. *Cost per freight ton-mile* (tonne-km) is also importance. This costing unit is found by dividing the cost of operating the vehicle by the number of freight ton-miles (tonnes-kms) carried (a ton-mile (tonne-km) being weight carried multiplied by length of the haul).

ROAD TRANSPORT

Of all forms of transport in the U.K., road haulage has shown a notable growth in recent years; today about 66 per cent of goods in Britain are carried by road, as compared with 17 per cent by rail, 14 per cent by coastal shipping and 3 per cent by other methods. Factors of cost, safety and speed have contributed to this situation. In particular, however, the popularity of road transport in the U.K. has stemmed from improvements in carrying power and reliability of vehicles and the capacity of the road system. Costs per ton moved by road have declined in real terms.

ROADS

Roads in Britain are categorised thus: trunk roads, including motorways which carry the bulk of long-distance haulage vehicles; classified roads; unclassified roads. There are 221,600 miles (356,640 kilometres) of public highway in the U.K. There are 10,098 miles (16,251 kilometres) of trunk roads, including 1,428 miles (2,298 kilo-

metres) of motorways, and 20,500 miles (32,909 kilometres) of principal roads, including 60 miles (96.6 kilometres) of motorways.

THE ROAD HAULAGE INDUSTRY

The road haulage industry is made up of 145,500 operators, many working in small units. The average size of a vehicle fleet is 4-5.

The *National Freight Corporation* is a public corporation, established by the *Transport Act* 1968 to operate certain types of road freight services. Currently it owns or leases 20,300 vehicles, 14,400 trailers and 12,100 containers; it employs 40,100 persons.

Freightliners Ltd., is owned jointly by the British Railways Board and the National Freight Corporation. Its operations are based on an extensive rail-road container transport system.

Licensing and other controls relating to road haulage vehicles are strict. With few exceptions, any vehicle of over $3\frac{1}{2}$ tons (3.56 tonnes) gross weight requires an operator's licence, the issue of which necessitates a demonstrated ability to maintain and handle the vehicle satisfactorily. Regulations relating to the pollution of the atmosphere and the carriage of dangerous goods are stringently enforced. E.E.C. road regulations affecting road haulage traffic are in the process of consideration and adoption by the U.K.

PUBLIC PASSENGER TRANSPORT

Publicly-owned operating units make up the vast majority of the U.K.'s road passenger transport system. The *National Bus Company* and the *Scottish Transport Group*, both formed under the *Transport Act* 1968, operate almost 25,000 vehicles. 5,500 privately owned firms, most operating no more than five vehicles per unit, provide 27,000 vehicles; few of these, however, are involved in the operation of scheduled bus services.

The *London Transport Executive*, set up under the *Transport Act* 1968, to replace the London Transport Board, is now responsible, under the Greater London Council, for the provision of underground rail services and scheduled bus services in the Greater London area. Over 60,000 staff are employed in the provision of services which involve 278 stations, 4,500 railway cars and 7,000 buses.

ADVANTAGES AND DISADVANTAGES

The main *advantages* of road transport are its convenience and flexibility. Goods can be conveyed from door to door without the elaborate loading arrangements required for rail and canal transport,

usually on the same vehicle and without the delay, risk of loss, damage or pilferage and very high labour costs involved when goods have to be transhipped from one means of transport to another, e.g., from a railway wagon to a road vehicle.

The *disadvantages* are less clear-cut but nonetheless real. They are mainly social and economic in that they affect the community at large rather than inflict a direct financial or operational penalty on the operator or his customer. A large number of heavy goods vehicles, of growing size and weight, is a severe strain on road surfaces and bridges, many of which were designed and built in the days of the horse and cart. The vehicles, unlike those of the railway which are provided with a clear track for their exclusive use, have to operate through the ordinary streets—often narrow—in close proximity to other road users. The result has been a rising toll of accidents. There are also the less tangible effects of vibration on the structure of adjacent buildings, of the noise, dust and atmospheric pollution caused by road vehicles, and of the effects of traffic jams and congestion caused by too many vehicles attempting to use the same road space.

As a result a considerable social and economic burden has developed, not only bearing on the cost of construction of new roads and bridges and the reconstruction of old ones, but also on medical, police and other public services. This has been followed by increasingly strident demands for greater legal restrictions on the use of road transport vehicles, for instance by compelling certain classes of goods to be carried by other means, by requiring purification of exhaust fumes, and by restricting the heaviest vehicles to designated routes.

INTERNATIONAL ROAD TRANSPORT

This has been greatly eased by the construction of roll-on, roll-off vehicle ferries and the use of semi-trailers which can be attached to a different driving unit at each end of the sea crossing, not only saving space aboard ship but also reducing the time driving units stand idle. The reduction of tariff barriers has also encouraged its growth. Many hauliers have depots or reciprocal arrangements for ensuring return loads in other countries.

The T.I.R. (*Transport International Routier*) system avoids the need for customs inspection and complications over payment of duty each time a vehicle crosses a frontier; this might happen several times before the vehicle reaches its destination. Under this system the cargo is inspected and sealed by the customs authorities in the country of departure and an accompanying T.I.R. carnet is endorsed. The

cargo then proceeds to its country of destination where customs officials break the seals, inspect the goods and assess duty in the normal way. The customs of intermediate countries merely check the carnet and see that the seals are unbroken.

There are still significant differences in the regulations for operating goods vehicles between one country and another. An operator must ensure that his vehicle meets the requirements of every country through which it passes. E.E.C. regulations, however, now dominate this area in increasing measure.

RAIL TRANSPORT

The growth of road transport has diminished not only the proportion of goods carried by rail in many countries but also the tonnage. Many lines have been closed to traffic. In most West European countries the goods train carrying miscellaneous freight on unbraked, loosely coupled wagons, which would be shunted and reformed many times en route, is a thing of the past. In these countries most goods traffic by rail fall into one of the following categories:

- (a) bulk transport of coal, oil, iron ore and other minerals;
- (b) *liner trains* in which the same set of wagons, usually of a specialised type, operate regularly over the same route, transporting under contract such items as car bodies, chemicals, milk, cement and refrigerated produce;
- (c) *container trains* operating between container depots to a fixed timetable;
- (d) parcels traffic, often carried on passenger trains and almost always handled at passenger stations;
- (e) conveyance of mails, newspapers and other topical or perishable goods.

Generally speaking, the greater the distance, the more attractive and competitive does rail transport become.

DEVELOPMENT AND OPERATIONS

The U.K.'s railways were brought under government direction for the first time during the 1914-18 war, and, in 1921, 130 private rail companies were amalgamated into four regional groups under the provisions of the *Railways Act* of that year. The *Transport Act* 1947 resulted in the railways being brought under public ownership as a single functioning enterprise. Substantial financial support from the government is given; specifically, British Railways' net annual losses are compensated by government funds.

British Rail's network consists of 11,189 miles (18,007 kilometres), of which 2,320 miles (3,735 kilometres) are now electrified. In 1977 a total of 702,000,000 passenger journeys was recorded and 178,000,000 tonnes of freight traffic were carried. 251,600 people are employed by British Railways Board; operating units include 3,500 diesel and 352 electric locomotives, 3,400 diesel and 7,200 electric passenger multiple-unit vehicles, 6,800 passenger carriages and 216,000 freight vehicles.

Among subsidiary operating units are included *British Rail Engineering, Ltd*, based on 13 repair and construction shops and employing some 35,000 people; the *Railway Technical Centre* at Derby, employing 2,500 people; *British Transport Hotels, Ltd*, which operates 30 hotels; *British Rail Shipping and International Services Division*, which operates a fleet of 56 vessels; *British Rail Hovercraft, Ltd*, which operates scheduled hovercraft services; *Transportation System and Market Research, Ltd*, which offers consultancy and management services relating to overseas transport operations.

PASSENGER SERVICES

British Rail's passenger services operations centre on the provision of a high-speed inter-city network and regular commuter services, particularly in and around London and the South-East. High-speed trains operate on most inter-city service routes and plans are in hand for the introduction of advanced passenger trains capable of speeds up to 155 miles per hour (250 km/h).

FREIGHT OPERATIONS

The transport of iron and steel, coal and coke, petroleum products, motor vehicles and their components constitute the largest tonnage of freight carried by the railways. A network of high-speed freight services has been designed, marshalling yards and terminals have been rationalised and operations concentrated in fewer, but more efficient units. Computer-based operating and freight processing systems have been introduced and obsolete freight vehicles withdrawn. The carriage of motor vehicles, milk, oil, grain, chemicals, newspapers, coal and gravel are based on long-term operating contracts. Express container services, comprising complete trains made up of permanently-coupled wagons, and operating from specially equipped transfer terminals, enabling the movement of containers from road to rail, are provided by Freightliners, Ltd.

EXPRESS PARCELS SERVICES

Three types of express parcels services are offered:

- (a) *Red Star Service.* This is an extremely swift service direct from station to station. Parcels may be taken to a selected station at least 45 minutes before the train departure time. Advance arrangements should be made for heavy or bulky packages. The parcel is expected to show the consignee's name (but not his address), the destination station and the sender's name and address. The consignee should be contacted immediately a parcel is sent. On production of evidence of identity he can collect the parcel from the destination station, normally 30 minutes after arrival of the train.
- (b) *C. & D. Service.* Collection and Delivery Service is available to any destination in the U.K. and Ireland. Parcels are collected from the sender's door, sorted by special automated machines and fed into cage trolleys for loading by fork lift on to trains. They are delivered to the consignees' door. Special rates and facilities are available for regular customers; agreed flat rates, which are highly competitive, may be negotiated. The C. & D. Service is in regular use by the distributive trades. Average journey times are 3 days nationwide or $2\frac{1}{2}$ days between principal centres.
- (c) *T.C.F. Service.* The "To Call For" Service is available between any two selected parcel stations. Parcels may be sent "station to station", or collection facilities can be made available at the forwarding end by Rail Express Parcels. In general, packages sent by T.C.F. are available for collection at the destination station within 24 hours of despatch. They may be stored free of charge for up to two days. Advance arrangements are expected for packages weighing over 2 cwt (0.1016 tonnes). Parcels sent under the service are identified by yellow T.C.F. labels and must show consignee's name (not address), destination station and sender's name and address.

Parcels to most European countries can be sent from main stations by Sealink ships, then, through the Continent, by train. Extra-urgent consignments can be arranged by air through *City Link Transport Services, Ltd.*, who operate a Red Star service to London Heathrow Airport via London terminal stations. A radio-controlled road shuttle service enables urgent consignments to be exported by road and air with speed.

RAILWAY RATES

Traditionally, railway companies have carried goods at fixed, published rates of so much per mile or kilometre for each class of goods, often with a reduction in the rate after, say, the first 100 miles. In Britain, however, the railways quote individually for each consignment within a charging policy laid down by senior management. This is intended to afford greater commercial flexibility and avoid the situation whereby business was lost merely because a road haulier quoted a price which he knew was slightly below the railways' fixed tariff. Large contracts are negotiated individually with the customer at a high level and a complete "package", including delivery times and frequencies as well as cost, agreed.

In general, the determining factors upon which rate-fixing is based include: distance to be carried; terminal charges; weight and loading matters.

Under the *Transport Act 1962* the railways ceased to be "common carriers"—a status which obliged them to accept virtually any type of goods offered to them for transport. They now enjoy the right to accept or reject any goods offered. The *General Conditions of Carriage at Board's Risk* make the Railways Board generally liable for the safety of goods carried, with the usual exceptions relating to, e.g., acts of God, strikes, etc. The *General Conditions of Carriage at Owner's Risk* place the onus of responsibility on the consignor, but he has the right to claim for damage or loss which can be attributed to wilful misconduct of the railway's employees.

REGIONAL OPERATIONS

For operating purposes, the railway system is divided into a number of regions, each with its own headquarters and each sub-divided into lines or areas. Under the area manager are normally a chief civil engineer (responsible for maintenance of the permanent way and other fixed equipment), a chief mechanical engineer (responsible for locomotives and rolling stock), an operating manager (responsible for time-tabling, supplies and day-to-day operations) and one or more traffic managers (responsible for attracting and handling goods and passenger traffic), as well as the usual clerical and administrative staff. Each depot or station, or group of small stations, is in the charge of a stationmaster or station manager. Efficient running demands considerable skill; every aspect of operations is covered by strict written regulations which make railway transport unusually safe and generally free from accidents.

The present five operating regions are the Eastern, London

Midland, Western, Southern and Scottish. Railway docks, hotels and other ancillary services are operated by separate executives. British Rail's large fleet of passenger and cargo ships, operating to Ireland and the European continent, has been formed into the *Sealink* consortium with S.N.C.F. (French national railways).

INTERNATIONAL RAIL TRANSPORT

As most European railway systems operate on the same standard gauge, through running of goods wagons has always been possible and a high degree of international co-operation and standardisation of procedures has developed. By means of train ferries, British goods wagons can be run through to Continental European destinations; in the reverse direction, however, only specially built continental wagons can run on British rails because of the smaller British loading gauge. Wagons have also been developed with wheels which can be adapted to run on the broader gauge railways of the U.S.S.R. and Spain. As an example, depots and storage warehouses have been developed in London at Stratford (for Scandinavian, Dutch, German and Belgian traffic) and at Bricklayers Arms (for traffic *via* French ports) to handle international rail freight.

CHAPTER TWENTY-SEVEN

Transport and Communication—II: Waterways, Sea and Air

WATERWAYS

Britain's inland waterways consist of 3,000 miles (4,828 kilometres) of canal and river navigation passages, 2,000 miles (3,219 kilometres) of which are in public ownership and are administered by the British Waterways Board. Regional water authorities administer some 500 miles (805 kilometres); the rest are under the control of local authorities, companies, charitable trusts, etc.

Among the most important of the inland waterways are the river Thames, Norfolk Broads, Leeds and Liverpool Canal, the Shropshire Union Canal, the Oxford Canal and the 35-mile-long Manchester Ship Canal. Other important commercial waterways are located in the Yorkshire-Humberside area. The Waterways Board is also responsible for the operation of its freight-carrying fleet, which works alongside a number of independent carriers, and for the maintenance of some docks, warehouses and inland freight terminals.

The advantages of canal transport include economies in the use of manpower, relatively cheap cost, suitability for bulky merchandise, such as iron, lime, coal and bricks, and for fragile merchandise, such as glass and pottery. Disadvantages arise from the restricted area covered by the canal system, the slowness of journeys resulting from the necessity of using the system of locks and the high costs of canal maintenance. These problems are reflected in the fact that the canal system carries less than 1 per cent of the U.K.'s total inland freight traffic.

SEA TRANSPORT

The principal advantage of shipping merchandise by sea is that, in simple terms of freight costs, transport is relatively cheap. Further, cargo ships are able to carry very heavy and bulky cargoes which cannot be handled by, *e.g.*, air or rail. The energy and manpower needed for this form of transport are relatively low. An important disadvantage is that sea transport remains slow and, therefore, not suitable when merchandise has to be exported and delivered in a short period of time.

Britain's merchant fleet is of considerable significance in international transport; today it carries almost one-fifth of the world's

sea-borne merchandise. Its 33 million gross tons makes it the third largest of the world's fleets (after Liberia and Japan). The oil tanker fleet is the third largest in the world, at 16 million gross tons; the ore and bulk carrier fleet is the world's fourth largest, at 8 million gross tons.

TYPES OF CARGO SHIP

General Cargo Ships. These are the most important of cargo-carrying vessels. They offer regular services between ports; dates of sailing and arrival are advertised. General cargo and a limited number of passengers may be carried. Unloading is by deck winch and dockside cranes.

Cellular container ships. These are specially constructed vessels able to carry over 1,000 containers. (Under the definition of the International Standards Association, a freight container is one designed to be of a permanent nature and capable of repeated use; designed specially for use by one of more methods of transport without any need of intermediate reloading; made with ready-handling devices; designed for ease of packing and emptying.) Some containers can be refrigerated.

Roll-on, Roll-off ships. Vessels of this nature allow vehicles to be driven on and then driven off at destination. The great advantage of ships of this nature is speed of turn-round, a matter of significance on short sea routes, such as the Dover-Calais crossing.

Tankers. These are designed to carry large cargoes of crude oil and refined petroleum products. Liquefied gas under refrigeration is also carried.

Other Bulk carriers. Ships of this type specialise in the transport of grain, etc., in bulk. Unloading is usually by suction process.

Hydrofoils and Hovercraft. Vessels of this nature have been developed in recent years and are based on high speeds. Some are used on short crossings for the carriage of passengers and their cars.

Tramps. Tramps do not operate on fixed routes and have no fixed, advertised times of sailing. They carry general cargoes to wherever there is a demand, or can be chartered to importers and exporters; *time charters* are based on set periods; *voyage charters* are based on port to port; bare-boat, or demise, charters, provide for all charges and maintenance costs to be the charterer's responsibility.

FREIGHT RATES

In general, rates for sea freight are determined by reference to weight, measurement or *ad valorem*, whichever is the greatest. Rates

vary according to commodity and destination possibility of return cargoes, demand for cargo space and availability of appropriate vessels. Special rates will be quoted for dangerous cargoes. Minimum freight rates for small consignments, irrespective of bulk and weight, are generally charged. Tramp rates are rarely fixed in advance and tend to be of a highly-competitive nature.

Freight rates may be paid in advance to port of destination; they may also be sent "freight forward", when the goods are collected by the shipping line prior to being handed over. Where goods have to be brought back to port of loading, because, for example, an importer refuses to take delivery, the shipping company may charge "back freight".

THE FIXING OF SHIPPING RATES: THE "CONFERENCE" SYSTEM

The fact that a liner must sail to schedule, whether it has a full load or not, induced liner owners to take steps to ensure that a reasonable minimum cargo should always be forthcoming. To this end the "Conference" system was evolved, *i.e.*, the owners formed associations to protect their interests. The first conference was arranged in 1875, when equal rates were fixed for each of the ports from which steamers within the associations sailed, and preferential rates were forbidden. But although this had the effect of maintaining rates, it did not protect liners from the competition of the tramps. This led to the introduction, in 1877, of the "*Deferred Rebate*" system, first applied to shipments of Manchester piece-goods to India. By this system, if goods were despatched by one line only, for a given period, then a rebate was allowed, computed on the freight charges paid during that period; but the rebate was paid over to the exporter only after a further period of loyalty to the shipping company. The system proved a great success and spread rapidly to most other routes, only coal and special shipments being excluded from the arrangement.

A system of discounts from freights in consideration of the signing of agreements to ship by none but conference vessels has largely replaced the allowance of deferred rebates.

The system of conferences has been extensively applied in the outward trades, and each conference has its own particular area. In addition there are arrangements between the various conferences for the division of territory where their routes intersect or overlap. These arrangements depend for their enforcement simply on the fear of retaliation, but they are nevertheless very loyally observed.

In the homeward trade the conference system is less general, owing mainly to the fact that the greater part of the import trade is in staple articles which move in bulk in large quantities and expect lower rates

than the liner can usually offer. Where, however, the cargo is an alternative to ballast, the liner may be prepared to underbid the tramp. The balance of trade is an important factor in the problem of securing the loyalty of customers. If, as in the Indian trade as a whole, the tonnage of outward traffic is below that of homeward traffic, the merchant in the latter case cannot be enticed by any rebate system.

CONTROL OF SHIPPING

Ocean transport is the most difficult of all forms of transport to control. But some regulation is essential; in Britain it is achieved through the Department of Trade. See *Merchant Shipping Act 1979*.

REGISTRATION OF SHIPS. To claim the rights of British nationality and to fly the British flag, a ship must be owned by British subjects and be registered in the Official Register (The Registrar General of Shipping and Seamen, with his head office at Cardiff, is responsible for the maintenance of the Register). Before a certificate of registration will be issued to the owners it is necessary for them to furnish elaborate particulars as to the hull, internal construction, tonnage, builder, master, etc. This registration certificate must always be carried on board, and it bears a number by which the ship is identified. The name of the ship and its port of registration must be painted on the stern, and the draught scale (in feet) must appear on both bow and stern.


MEASUREMENT OF SHIPS. The measurement of a ship determines the total capacity of the vessel, by which is regulated the amount of the cargo it can carry and the port and canal dues, etc., which it must pay. A ship is described as being of so many "tons register" (which is its gross *registered* tonnage based on its measurements), and its capacity is ascertained by measuring all *covered* space in cubic feet and converting into tons at the rate of 100 cubic feet per ton. The *net tonnage* is also registered and is the more important measurement. It is calculated from the gross tonnage by making allowances for space occupied by the crew and engines or used for purposes of navigation. The *cargo capacity* can be stated in what are known as "measurement" tons. A measurement ton is usually 40 cubic feet, and a ship-owner has the option of giving a freight quotation in either measurement tons or ordinary "dead-weight" tons.

THE FREEBOARD AND LOAD-LINE MARK ("Plimsoll's" mark) is painted on the ship to indicate the maximum depth to which it may be allowed to sink in the water. More than one line is marked separately on the "Grid", since the depth of the immersion varies according to

the salinity of the ocean and time of the year. Thus, the highest mark (nearest freshwater mark) is that for tropical waters (summer) and the lowest that for the North Atlantic (winter).

LLOYD'S REGISTER OF SHIPPING

Almost as important as the control by the State is the semi-official control by Lloyd's Register of Shipping, which originated in the necessity for a marine insurer to know something of the vessel he was asked to insure. The famous "Ships' Lists" from which Shipping Registers originated were first drawn up in Edward Lloyd's coffee-house, where shippers, underwriters and captains used to congregate. Shipping registers as at present known were first printed in 1734, but the present Lloyd's Register of Shipping came into existence much later in 1834.

Classification of a ship is made from two standpoints, hull and equipment, the first being classified alphabetically, the second numerically: thus, a ship whose hull and equipment are both regarded as first-class is described as  100 A1, the Maltese Cross indicating that the ship was built under continuous survey by Lloyd's surveyors.

As a general rule, every vessel over 100 tons is entered on the Register, but no vessel is classified unless it conforms with the Rules of the Register as to design and construction.

The Register is controlled by a general committee of seventy-two members, who represent all interests and places, while, in addition, there is a technical committee of fifteen, consisting of naval engineers, architects, shipbuilders, forge-masters and representatives of the iron and steel industry, which draws up rules for the construction of any ship which is to be registered.

BRITAIN'S PORTS

Britain's ports handle over 335 million tonnes of cargo annually, a large proportion of which is carried in containers and roll-on goods vessels. Some 250 port authorities and public wharf operators and 800 other enterprises responsible for harbour operations, *e.g.*, stevedoring and warehousing, employ about 65,000 workers, of whom 30,000 are dockers registered with the National Dock Labour Board. Port authorities include the nationalised bodies, public trusts, statutory companies and local authorities. The nationalised undertakings constitute over 25 per cent of total capacity.

The *National Ports Council* advises the Secretary of State for Transport on port affairs in general, exercises certain statutory

functions and provides advice and assistance to the industry. Members are appointed by the Secretary of State and include 8–12 persons selected from areas of expertise including harbour management, inland transport, shipping, etc. The Council's permanent staff, under a Director-General, consists of a Secretariat and specialist divisions of economics and statistics, finance, manpower and technical services. Revenue is obtained by a levy on harbour authorities. The Council has the specific duty of advising on matters such as major harbour development plans, loans towards the cost of projects of this nature, regulations prescribing the form and content of the accounts of harbour authorities. The Council has statutory responsibility for considering objections to ship, passenger or goods dues levied by harbour authorities.

Britain's principal ports are headed by London, the largest port for non-fuel traffic. Southampton, with its advantageous deep water and double tides, is now the main port for ocean passenger traffic. Medway is of much importance for the handling of petroleum products. Dover, Felixstowe and Harwich handle large numbers of passengers and a growing quantity of roll-on, roll-off traffic. Liverpool occupies a position of importance in relation to exports, particularly to non-European ports. Manchester's inland port handles chemicals and manufactured goods. The port of Tees and Hartlepool deals with chemicals, iron and steel and chemicals. Milford Haven has become the major oil port in Britain. Scotland's principal ports include Greenock, Glasgow, Grangemouth, Leith and Aberdeen. Northern Ireland's main port is Belfast.

Purpose-built oil terminals are being expanded rapidly, the first having been completed at Hound Point on the Forth in 1975. The largest oil port in Britain is to be developed at Sullom Voe in Shetland; it is likely to become the largest oil port in Europe. Terminals have been built on the Tees and at Flotta in Orkney.

AIR TRANSPORT

Transport of goods by air has grown in recent years at a faster rate than other modes of transport so that, today, almost 17 per cent by value of the U.K.'s exports are carried by air. Freight is carried by passenger aircraft and special freight planes to most of the world's major cities. Services generally available are set out in *Cargo by Air*, a supplement to *Lloyd's Loading List*.

Some types of goods lend themselves particularly to carriage by air and these include: goods of small bulk but high value, *e.g.*, diamonds; emergency supplies, *e.g.*, medicines; perishable goods, *e.g.*, fruit. The principal advantages of air shipping are speed and the existence of

handling facilities close to major cities. Disadvantages relate to cost and difficulty of transporting large and bulky merchandise.

BRITISH AIRWAYS ORGANISATION

British Airways came into existence as a result of the merger of British Overseas Airways Corporation and British European Airways in 1974. It is now one of the world's leading airlines and carries more passengers on international scheduled services than any other airline. The chairman and members of the Board of British Airways are appointed by the Secretary of State for Trade, to whom they are responsible. Airline operations are organised in departments such as commercial operations, flight operations, planning, catering, personnel and engineering. Four companies are concerned with subsidiary and related activities—British Airways Associated Companies, Ltd, British Airways Engine Overhaul, Ltd, British Airways Helicopters, Ltd, and International Aeradio, Ltd. Commercial airline operations are based on six groups of routes: one covers the U.K. and Irish Republic; two cover continental Europe (one North and East, the other, West and South); three cover Eastern, Southern and Western inter-continental services.

British Airways' net assets in 1977 amounted to £692 million, including £514 million of aircraft and spares and £95 million of property. Its sources of finance include reserves of £99 million, borrowings of £222 million and public dividend capital of £290 million. Capital expenditure in 1976-77 was £178 million.

BRITISH AIRWAYS' SERVICES

British Airways' route network is now the world's largest, and covers 150 cities in over 80 countries. Scheduled services operate to the rest of Europe, the Middle and Far East, East and South Africa, Australasia, North America and Guyana. Over 1,400 flights a week are run to 28 cities and towns throughout Britain. 14.5 million passengers were carried in 1977 on scheduled services, of whom 10 million were on international services. The passenger fleet, the world's largest for airlines operating international services, includes 192 aircraft and helicopters. In recent years British Airways inaugurated jointly with Air France the world's first supersonic passenger services, based on Concorde aircraft, on the London-Bahrain and London-Washington routes. Improved methods in ticket selling and seat booking have been made possible by the use of a computer based at Heathrow.

AIRPORTS

The two major airports in the London area are Heathrow and Gatwick. Other leading airports include Luton, Manchester, Glasgow, Belfast, Edinburgh and Aberdeen. Airports policy is under review by the Government and it is expected that plans will be formulated and announced to deal with an expected heavy increase in the numbers of passengers and volume of freight in the 1980s. The number of people employed by British Airways, almost 60,000 in 1977, based largely at the major airports, is expected to increase as the rate of traffic handling increases.

AIR FREIGHT RATES AND AIR FARES

Air freight rates are controlled in large measure by the International Air Transport Association (I.A.T.A.) to which almost all the world's airlines belong. As a result there is little effective competition between these airlines in freight carriage rates. Freight is charged at so much per kilogram; in the case of bulky goods with a volume in excess of 7,000 cm³/kg, charge is generally based on volume. Rates are based on six classifications: specific commodity rates; special rates for internal services; classification rates applying to animals, valuable cargoes, newspapers, etc.; general cargo rates; unit load device rates applicable to containers and pallets (*i.e.*, loads made up of goods anchored to a pallet or base made of metal or wood); economy pack rates.

Domestic fares in the U.K. are controlled by the Civil Aviation Authority, which is an independent statutory body with general responsibility for the economic and operational regulation of the industry.

CHAPTER TWENTY-EIGHT

The Post Office

The Post Office, previously a government department, became a public authority under the *Post Office Act* 1969 and is at present the responsibility of the Department of Industry. Its chairman and board members are appointed by the Secretary of State for Industry.

The many services for which it is responsible employ some 401,000 persons and utilise £7,000 million worth of plant. It administers 23,100 post offices, 78,000 public telephone call offices, 29,000 telex connections and 20 mechanised sorting centres. During 1977-78 it handled 9,903 million letters and 160 million parcels. Its income in 1977-78 was £4,183.2 million; a profit of around £367.7 million was earned.

The *Post Office Guide*, the official Handbook of the Post Office, is published annually and contains full particulars of the organisation's vast range of services. Supplements to the *Guide* and explanatory leaflets are issued at regular intervals.

Examples of the services rendered to commerce by the Post Office are considered in this chapter under three general headings:

- (a) Inland Post;
- (b) Overseas Post;
- (c) Telecommunications.

INLAND POST

Among the exclusive rights possessed by the Post Office is the privilege of "carrying letters from place to place and of performing all incidental services such as those of collecting and delivering letters".

LETTERS AND CARDS

Letters and cards may be sent by two classes of service: first class and second class. In general, second class mail is delivered up to two working days later than first class. No written indication of service is required on the letter except where this is separately specified. There is no weight limit for first-class mail; there is a limit of 750 g for second class letters. Where large numbers of letters (minimum: 4,251) are posted in bulk, a rebate of postage may be applied for; rebate items may, however, be liable to be kept back in favour of fully-paid mail and are usually dealt with in off-peak periods.

BUSINESS REPLY SERVICE

A person who wishes to obtain a reply from a business client may include in his letter to that client an unstamped reply card, envelope, letter card or gummed label of special design which includes the statement "Postage will be paid by licensee" and the licence number pertaining to the Business Reply Service. Licences are obtainable from the local Head Postmaster and the licensee pays in advance a sum of money sufficient to cover the amount of charges likely to accrue during one month. Further payments may be required to renew credit.

FREEPOST SERVICE

Business communications or advertisements may include a special address and the reply bearing that address may be posted in the ordinary fashion, but need not bear a stamp; the addressee pays postage on each reply received. A licence to use the service is obtainable from the Head Postmaster of the district in which the licensee resides or from which his business is operated; the Head Postmaster specifies the exact terms of the address. The licensee pays in advance money sufficient to cover the postal charges likely to accrue during one month. Further payments may be required. Delivery is usually made once daily on the second delivery.

PARCELS

The maximum weight of inland postal parcels is 10 kg. Maximum dimensions are: length, 1.070 m; length and circumference combined, 2 m. Postage on parcels other than postage forward parcels must be prepaid except where the sender has a postage account. Parcels must be marked "Parcel Post" and handed over a post office counter. Certificates of posting may be obtained. For the regular large posting of parcels (minimum: 2,500 per annum) parcel contracts are available.

The *Postage Forward Parcel Service* is intended for business firms who wish to obtain parcels from clients without those clients having to pay postage. Specially-designed unstamped addressed labels or wrappers may be sent to clients; the parcel can be posted without a stamp and the addressee pays postage on parcels received. Licences are obtainable from Head Postmasters with whom licensees must deposit money to cover charges.

A "Compensation Fee" parcel service is available, for firms who wish to cover the contents of inland parcels for compensation in the event of loss or damage and to have a record of posting.

FRANKING MACHINES

Authority for the use of franking machines must be obtained from the local head post office. Machines may be leased or purchased only from companies authorised by the Post Office; only the supplying companies may repair or modify the machines and inspection is essential at least twice in a period of six months. Franked correspondence must be handed in at a specified post office or posted in special envelopes in boxes agreed by the Head Postmaster.

METHOD OF ADDRESS AND POSTAL CODES

A correct postal address consists generally of the following information: name of addressee; number or name of house; name of street or road; locality name, *i.e.*, to distinguish between streets of the same name in the same postal delivery area, where required; post town, which should be shown in block capitals; county name, where required; postcode.

A *postcode* is used in the mechanised sorting of mail and comprises a group of letters and figures. There is a Postcode for every address in the U.K., except the Channel Islands and the Isle of Man. Postcode Directories are available to business firms free of charge.

PROHIBITED ARTICLES

A variety of articles will be refused by the Post Office, or, if found in the course of transit, detained. Prohibited articles include: dangerous articles, such as explosives, certain toxic substances, sharp instruments and matches. Living creatures (with some few exceptions), counterfeit currency notes are further examples of prohibited articles.

FREE COLLECTIONS

On application to the local Postmaster, a business firm may arrange for the free collections of first and second class letters, where the number totals 1,000 or more, or total postage amounts to £70 or more. Regular, free collections of parcels where there are at least 20 at a time may be made. Special collections of ordinary parcels where the number at one time is 100 or more may be arranged without charge.

EXPRESS SERVICES

The following services are available for business firms: *express*, in which an article will be conveyed all the way by Post Office

messenger; *railcx*, in which a postal packet is conveyed by Post Office messenger to a railway station for transmission by the first available train and is delivered by messenger from the station of destination.

SPECIAL DELIVERY

This service allows the sender of a postal packet to arrange for special delivery after its arrival at the post office of delivery. It is available only during the hours when special messengers are on duty. Letters intended for special delivery must be boldly marked above the address on the left-hand side of the letter cover.

DATAPOST

This overnight delivery service involves the collection of packages from customers at agreed times and delivery at agreed times during the next morning. Applications for the service are made to the local Head Postmaster. The service is available on a contractual basis, charges being negotiated individually.

RAILWAY LETTERS

Under an agreement with British Rail, first-class letters may be accepted at certain stations for transmission to other stations, to be transferred to the post or to be called for. In addition to the appropriate first class rate, a railway fee is chargeable.

AIRWAY LETTERS

British Airways will, under agreement with the Post Office, accept first class letters at designated airports and carry them on the next available flight, to be collected at the airport terminal of destination or to be transferred to the post.

CASH ON DELIVERY SERVICE

Use of this service involves the transmission of goods sent in response to requests made by or on behalf of the addressee. A *trade charge form* must be completed by the sender, stating the value of the goods to be paid for on delivery. On the cover of the packet must be written the names and addresses of sender and addressee and the amount of the trade charge.

Letters and packets must be registered. The amount to be collected on delivery should not exceed £100. In addition to the normal

registration and postage charges, there are added C.O.D. charges. Generally, a C.O.D. package is delivered by a postman against payment of the appropriate trade charge. Where the trade charge is in excess of £50, the package may be kept at the local post office and notice sent to the addressee who may be required to make payment at that office.

REGISTRATION

It is possible to register any first class letter, except one transmitted by airway or railway. Registration fees are payable over and above postage. The fees cover compensation for loss or damage. A certificate of posting, including acknowledgment of payment of registration fees, must be obtained. Registered letters must be handed to an official of the Post Office; they must not be placed in letter boxes. Special envelopes are required for transmission of bank notes, coin, saving stamps, etc.

RECORDED DELIVERY SERVICE

Under this service, a business firm obtains a record of posting and delivery; limited compensation is available in the event of damage or loss. Most postal packets, except parcels, railway and airway letters and C.O.D. packages may be sent by this service. Banknotes, coin, jewellery may not be sent by this service. Recorded delivery fees are prepaid, in addition to ordinary postage. Addresses are written on special delivery receipt forms obtainable at local post offices. A label is stuck on the packet above the address. The packet and receipt form are handed to an official of the Post Office; he will complete the receipt and hand it back to the poster. Packets intended for recorded delivery must not be placed in letter boxes.

A receipt is obtained on delivery to the addressee and is kept at the delivery office. No undertaking is given by the Post Office to deliver recorded delivery packets to addressees in person.

OVERSEAS POST

Overseas postage fees and rates are set out in the *Postal Rates Overseas Compendium*, issued free of charge to business firms, as a supplement to the annual *Guide*.

AIR MAIL SERVICES

Under the "All-up Service", letters, letter packets and postcards for Europe will be conveyed by air where this results in earlier postal

deliveries. No special charges for air conveyance are made and special air mail marking is not needed. Air parcels, however, must carry blue air mail labels affixed close to the address.

Where mail is sent to countries outside Europe, items must bear the appropriate air mail labels, or the written or typed phrase "PAR AVION (BY AIR MAIL)". Air letter forms are also available. The *Small Packet Post* is available for the transmission by air of packets weighing, in general, not more than 1 kg; these packets cannot be insured.

INTERNATIONAL REPLY COUPONS

These may be purchased from the larger post offices and can be exchanged in most countries for stamps representing minimum international postage payable on letters sent abroad. When received in the U.K. they may be exchanged for stamps to the value of the current postage rate for a 20 g overseas surface letter. The *Universal Postal Convention* regulates the price and exchange rate of reply coupons.

PARCELS

The maximum weight of parcels transmitted by the overseas parcel post service is, as a rule, 10 kg. Overseas parcels may be insured; they may not be registered. It should be noted that in some countries a small delivery fee is payable. Contents of parcels sent abroad by post must be declared to Customs by the sender and directions must be given for disposal in the event of non-delivery.

EXPORT LICENSING AND CURRENCY CONTROL

The export of some goods requires special licences issued by the Export Licensing Branch of the Department of Trade. *Specific licences* are issued where goods are to be sent by a single posting. *General, bulk, licences* are issued where goods are intended for despatch over a specified period of time.

Currency regulations are strict, so that, in general, currency notes of any description or origin may not be sent to any destination outside the U.K., except by an authorised bank. There are restrictions, too, in the case of postal orders.

REGISTRATION AND INSURANCE

Postal packets for overseas with the exception of parcels and some printed paper items, may be registered. Certificates of posting must

be obtained and the packets should not be placed in letter boxes, but must be handed to post office officials.

Insurance extends to most countries and covers sums up to £600. An insured packet may not always be transmitted by the ordinary routes; hence delivery may take longer than usual. Certificates of posting must be obtained for insured packets. The Post Office accepts no liability for any loss or damage arising from defects in insured packets which may not be observed at the time of posting.

TELECOMMUNICATIONS

Business firms and their customers are among the many beneficiaries of the prodigious advances in telecommunication theory and practice pioneered in recent years by the Post Office. Very high standards in speed and accuracy of transmission have been attained, which are reflected in the aspects of telecommunications referred to below.

INLAND TELEGRAMS AND TELEGRAM MONEY ORDERS

Inland telegrams may be sent between any addresses in Great Britain, Northern Ireland and the Isle of Man. Business firms may register with the Post Office a registered telegraphic address for use in inland telegrams. Telegrams may be handed in at most post offices; they may be dictated by 'phone or may be originated by telex.

Telegraph money orders are issued from any post office from which telegrams are usually despatched. They are obtainable for any sum not exceeding £100. For a supplementary fee, the sender can be informed by post of the date of payment of the order.

EXTERNAL TELEGRAMS AND INTERNATIONAL TRANSFERRED ACCOUNTS

International telegrams may be transmitted to most countries, to ships in port and to aircraft at terminals. Supplementary facilities include: prepaid replies; notice of time of delivery made by telegram to sender; certified copies; special hand collection from sender's address.

The *international transferred account telegraph service* allows charges of international telegrams to be paid by the addressee or some other person or body who has indicated acceptance of responsibility for payment.

TELEX SERVICE

This service makes available a swift method of printed communication. Teleprinters at the sending and receiving

installations, which are fully automatic, allow messages to be sent and received in print-out form even though they are unattended, as when a firm's premises are closed. Immediate connection can be made by direct dialling to any subscriber in the U.K. Some subscribers in Europe and elsewhere can be reached by direct dialling; where direct dialling is not possible calls can be connected by the London exchange operators.

PICTURE SERVICES

Photographs, diagrams, plans, shorthand and other commercial information can be telegraphed in facsimile from London to many places abroad by use of line circuits and radio links. A phototelegram can be posted direct from the office of receipt by express or registered post. The maximum size of matter to be transmitted is 25 cm × 23 cm.

The Post Office also provides international circuits enabling the exchange of pictures between PV/PV picture transmitting-receiving stations in the U.K.

DATEL AND CONFRAVISION SERVICES

Telex networks or leased telegraph circuits may be used, in modified form, to allow the transmission of data prepared in any 5-unit code on punched paper tape. Digital data transmission is based on very high speeds: thus, transmission at rates of up to 110 bits per second (a "bit" is a binary digit) is possible over telegraph circuits, and up to 4,800 bits per second is possible over speech circuits. Much higher speeds may soon become practicable as the result of the use of special waveband circuits.

Confravision links groups of persons, e.g., a firm's officials and its advisers or customers, in sound and vision, so that conferences of groups in different locations can be held. Studios are now in use in London, Bristol, Birmingham, Manchester and Glasgow.

RADIOTELEGRAPH AND RADIOTELEPHONE SERVICES

Radiotelegraph services from shore to ship and radiotelephone services of a similar nature are available. Calls must be booked through the *Ships' Telephone Service*; radiotelegrams are accepted at most post offices. In some cases, where ships are provided with appropriate equipment, calls may be made from ship to shore.

TELEPHONE SERVICES

The largest telephone system in Europe (and the third largest in the world) is controlled by the Post Office; there were 23·3 million telephones in the U.K. in March, 1978. Since 1958, trunk dialling by subscribers (STD) has become generally available. International subscriber dialling (ISD) links the U.K. with 35 countries by means of cable networks, microwave radio links and radio systems. Communication satellites in space are also in use.

Private branch exchanges (PBX) are installed by the Post Office on request in the premises of firms in which a large number of telephone extensions are in use. Other specialised telephone services available for business firms include the provision of recorded information relating to the *Financial Times Share Index*, business news summaries, stock market reports and a business diary of important events. The "Freefone" service allows business firms to permit their agents and customers to make calls to them without the callers having to make payment.

POST OFFICE RESEARCH

The Post Office spends £40 million annually on research and development, much of it carried out in collaboration with universities, technical institutions and industry. Its new research centre at Martlesham Heath, Suffolk, is a focal point of investigation and experiment, some aspects of which promise fundamental and far-reaching changes in business communications. The development of microelectronic silicon circuits and the replacement of electro-mechanical telephone switching systems by apparatus controlled by stored-program computer exchanges is of considerable significance. The operation of private business telephones by a credit card ("card-phones") is now possible and apparatus controlled by the insertion of a card upon which the value of a call is registered electronically is to be introduced following the completion of tests. "Prestel", known formerly as "Viewdata", a service which will allow a telephone subscriber to obtain information prices, stock values, etc., in a form which can be displayed on a domestic television receiver, is under development. The day of the "cashless society", in which it will be possible to view, select and order goods without leaving one's home and in which the customer's banking account will be debited automatically by Post Office-controlled computers has moved much nearer. The combining of electronics and photonics, whereby lasers, computers, 'phone links and display screens transmit, receive, process and display information at very high speed, is the subject of intensive

research. The use of lasers and glass fibres for the carrying of telephone messages is under investigation. The effect of technology of this nature upon commercial communications will be profound.

(For references to Post Office banking services, see Chapters 32 and 36.)

V

RSEAS TRADE

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Part V

OVERSEAS TRADE

CHAPTER TWENTY-NINE

Structure and Problems of Britain's Overseas Trade

Trade takes place because there is an advantage to be gained from it. This is true of all trade, whether it is carried on between persons in a country or between people in different countries. But there are marked differences between trade carried on inside a country and trade between countries.

A country is a distinct economic entity, with its own laws, its own monetary system, and often its own language. These differences create barriers which hinder the movement of labour and capital on through the medium of the foreign exchanges and the flow of goods is affected by the efficiency of transport, by tariffs and quotas, and by political factors.

THE THEORY OF FOREIGN TRADE

Foreign trade is an extension of the principle of the territorial specialisation of industries. Some localities are more suited than others to produce certain classes of goods because they have natural or special advantages. Britain buys oranges and bananas from Spain, the West Indies and other countries which have the necessary natural conditions for their cultivation. In other cases, as with the import of wheat into Britain, the trade is necessary because a country cannot satisfy all its requirements from the limited home production possible. The reason for the development of trade in such cases is obvious; the country that produces the product has an *absolute advantage*, but there is another set of conditions in which trade arises.

A country or region may import goods which it could itself produce at a lower cost than the country from which it gets the goods. Britain, for instance, is an excellent dairy farming country but she imports part of her dairy produce from other countries less efficient in this respect, and concentrates her resources on the production of machinery, electrical equipment, etc., in which she has a greater advantage than she has in dairy produce. The principle involved in determining the direction of effort where a region has an advantage in the production of more than one commodity is known as the *law of comparative costs*.

Suppose that with one unit of expenditure, there can be produced in

Country A	Country B
100 units of wheat	80 units of wheat
or	or
80 units of machinery	40 units of machinery

Country A has an advantage over Country B in both commodities, the advantage being greater in the production of machinery and it will therefore specialise on machinery while Country B specialises on wheat production. If both countries had used one unit of expenditure on each commodity, there would have been produced with a total expenditure of

4 units—180 units of wheat
120 units of machinery

By specialising

Country A produces with 2 units of expenditure	160 units of machinery
Country B produces with 2 units of expenditure	160 units of wheat

As, in terms of resources costs, machinery is the more valuable commodity in both countries there is a *net gain in specialisation and this is shared by the two countries*.

In general terms, the advantages of international trade are considerable: as indicated in the example above, nations can specialise in the production of commodities and services in which they are best fitted; nations are able to enjoy a wide range of products which they are unable to produce at home; nations are enabled to obtain commodities more cheaply than their home production would allow; a wider variety of products and services becomes available to trading nations; competition from overseas sources tends to stimulate efficiency among home producers. For the trading nations as a whole the standard of living is improved.

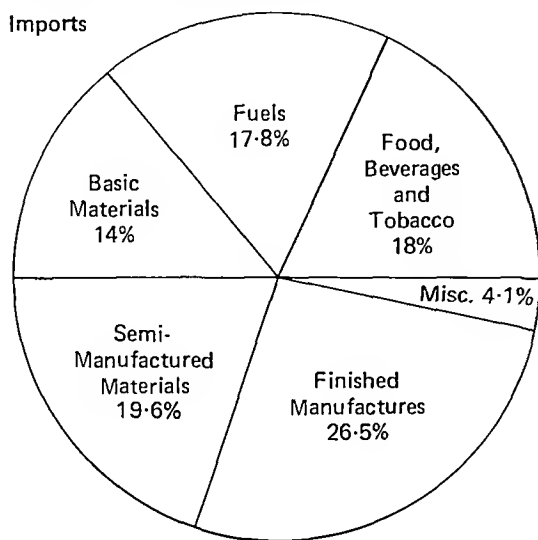
BRITAIN'S PATTERN OF OVERSEAS TRADE

Britain is seventy-fifth in area among the world's nations. It has 0.18 per cent of the world's total land area but is the fifth largest trading nation, although having only 1.4 per cent of the world's population. Almost half its total consumption of foodstuffs is accounted for by imports as is the majority of the raw materials used by its industries. It is one of the world's largest importers of food,

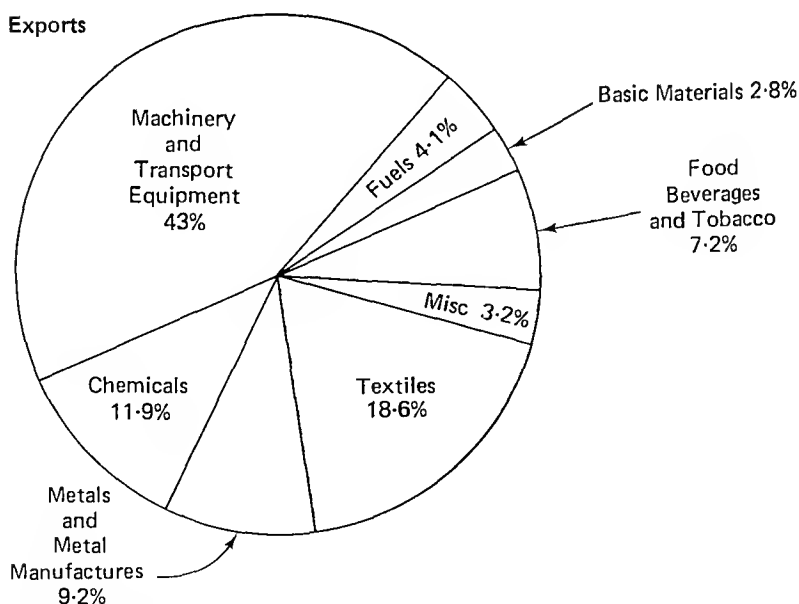
metals, petroleum and timber; it is one of the largest exporters of machinery, vehicles, electrical apparatus and chemicals, its exports accounting for over 20 per cent of gross domestic product.

The diagrams below illustrate Britain's area pattern of trade

Imports

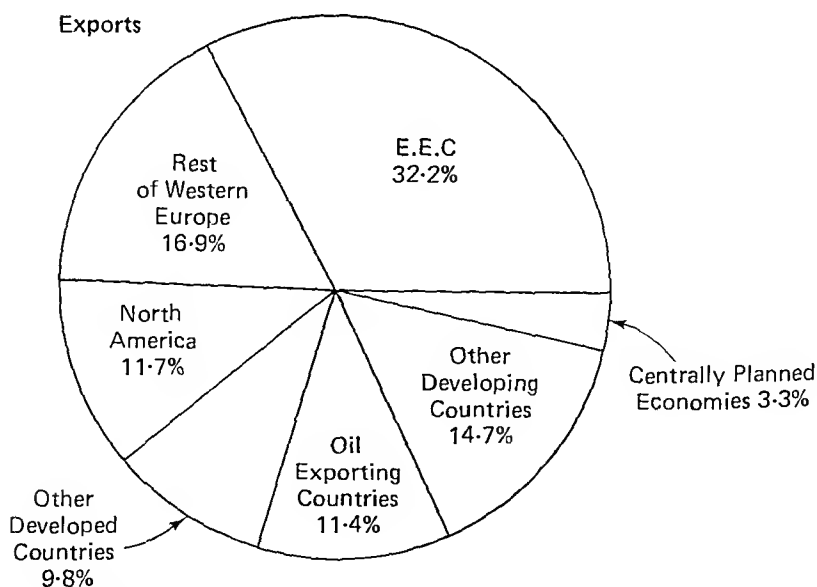
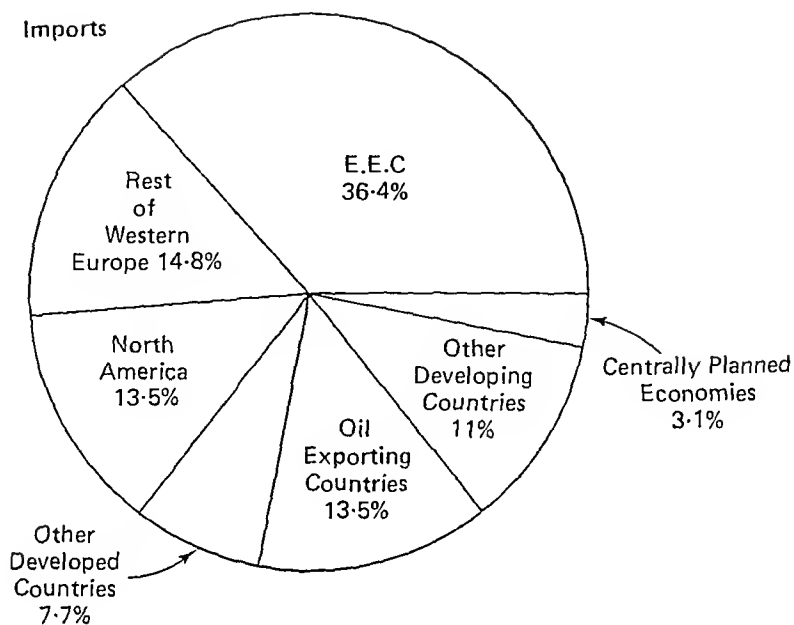


Exports



Britain's Pattern of Commodity Composition of Trade in 1976

Source: Department of Trade



Britain's Area Pattern of Trade in 1976

Source: Department of Trade

BRITAIN'S PRINCIPAL MARKETS 1976		BRITAIN'S PRINCIPAL SUPPLY SOURCES 1976	
<i>Exports to (f.o.b.)</i>	<i>£ million</i>	<i>Imports from (c.i.f.)</i>	<i>£ million</i>
U.S.A.	2,447	U.S.A.	3,024
Germany, Federal Republic	1,833	Germany, Federal Republic	2,755
France	1,708	Netherlands	2,425
Netherlands	1,498	France	2,089
Belgium and Luxembourg	1,400	Belgium and Luxembourg	1,300
Irish Republic	1,246	Sweden	1,186
Sweden	1,045	Canada	1,159
Switzerland	1,000	Italy	1,103
Italy	825	Iran	1,046
Nigeria	773	Irish Republic	1,006
Australia	687	Saudi Arabia	977
Denmark	654	Switzerland	961
South Africa	645	Japan	795
Iran	513	Denmark	704
<i>Total to all countries</i>	<i>25,756</i>	<i>Total from all countries</i>	<i>31,152</i>
E.E.C.	9,168	E.E.C.	11,384
Rest of Western Europe	4,272	Rest of Western Europe	4,577
North America	3,087	North America	4,217
Other developed countries	1,943	Other developed countries	2,116
Oil exporting countries	3,146	Oil exporting countries	4,207
Other developing countries	3,359	Other developing countries	3,511
Centrally planned economies	726	Centrally planned economies	1,109
Low value trade	55	Low value trade	31

Source: Department of Trade

and the commodity composition of trade. The tables above show Britain's principal markets and sources of supply.

BALANCE OF TRADE AND BALANCE OF PAYMENTS

Britain's trading relationships with the rest of the world result in inward and outward flows of money, goods and services. An outflow of exports from Britain will result in an inflow of payments; an inflow of imports into Britain will result in an outflow of payments. The general financial results of overseas trade are recorded and published at regular intervals by the Government's statisticians in the form of tables showing the U.K.'s *Balance of Payments*. Since 1970 the tables record transactions referring to *current account* (indicating export and import of goods and services), *currency flows* and *financing*.

The following table summaries the balance of payments for 1975-77.

	1975 £m	1976 £m	1977 £m
CURRENT ACCOUNT			
Visible trade: Oil	-3,111	-3,973	-2,804
Other goods	-94	+463	+1,192
Invisibles	+1,591	+2,403	+1,577
Current balance	-1,614	-1,107	-35
Current balance	-1,614	-1,107	-35
Capital transfers	—	—	—
Investment and capital flows:			
Official long-term capital	-288	-158	-302
Overseas investment in United Kingdom public sector	+43	+203	+2,179
Private investment (net)	+336	-92	+1,219
Overseas currency borrowing or lending (net) by United Kingdom banks	+235	-106	+265
Changes in external sterling liabilities	-67	-1,152	+1,452
Trade credit and other short-term flows	-56	-1,501	-11
Balancing item	-54	+285	+2,596
Balance for official financing	-1,465	-3,628	+7,363
Financed as follows:			
Drawings on IMF	—	+1,018	+1,113
Drawings on other monetary authorities	—	-34	—
Foreign currency borrowing:			
By Her Majesty's Government	+423	—	+871
By United Kingdom public sector under the exchange cover scheme	+387	+1,791	+241
Drawings on (+)/additions to (-) official reserves	+655	+853	-9,588

Source: Treasury Statistics

ITEMS IN CURRENT ACCOUNT

The following terms should be noted:

- (a) *Visible trade*. This refers to exports and imports of goods. The importance of oil imports is seen clearly. The term "visible trade" is known also as "balance of trade"; it records the difference in value of imports and exports.
- (b) *Invisibles*. This refers to the import and export of services, *i.e.*, the U.K.'s "invisible trade". Among the more important items are: transactions in services between the U.K. Government and recipients overseas, *e.g.*, embassies; earnings of ships owned by British operators; receipts from the use of British airlines; personal expenditure in the U.K. by visitors from abroad; interest and dividends accruing to, or payable by, U.K. residents; net earnings of U.K. insurance and banking firms; cash gifts and payments made by U.K. residents to persons overseas.
- (c) *Current balance*. This term is also known as "balance on current account". There is said to be a *favourable balance* on current account when the value of goods and services exported exceeds the value of goods and services imported; there is said to be an *unfavourable balance* on current account when total imports of goods and services exceeds total exports of goods and services. A favourable balance over a period of years indicates that a nation is paying its way; a continuing unfavourable balance is a cause for concern since it suggests that a nation is consuming more than it is producing.
- (d) *Balancing item*. This figure is used so as to balance the account; it records the net total of errors and omissions in other items.
- (e) *Drawings on I.M.F.* This item refers to the U.K.'s drawings and repurchases from the International Monetary Fund (I.M.F.), which is discussed in Chapter 40.

TERMS OF TRADE

The U.K.'s terms of trade denote *the rate at which its exports exchange for its imports*. If the U.K.'s exports become cheaper in relation to its imports, so that, in effect, the U.K. gains fewer imports in exchange for every unit of its exports, the terms of trade are said to have worsened, or moved unfavourably. The terms of trade are said to have moved in favour of the U.K. if her exports become dearer relative to her imports.

The numerical value of terms of trade may be calculated thus:

$$\text{Terms of Trade} = \frac{\text{Index of Exports}}{\text{Index of Imports}} \times 100$$

The following table shows the U.K.'s terms of trade in relation to the base year 1970.

Year	1970	1971	1972	1973	1974	1975	1976
Terms of trade	100.0	100.9	101.3	90.2	74.6	80.8	80.4

Source: Economic Trends (H.M.S.O.)

DEFICIT ON CURRENT ACCOUNT

Since the end of the Second World War the U.K. has experienced a series of economic crises resulting from deficits on current account. These crises had their roots in the effects of the war, in which physical destruction of assets, loss of overseas markets and the sale of overseas assets combined to change the status of the U.K. from that of the world's largest creditor to that of one of the world's largest debtors. Persistent inflation, resulting in large measure from unprecedented increases in the price of imported oil, and world-wide industrial recession have also contributed to the U.K.'s balance of payment difficulties.

Corrective measures taken by successive governments have included, for example, direct restrictions on imports into the U.K., in the form of import surcharges and quotas (*i.e.*, limitations on the volume of imports in a stated period of time); promotion of exports by government action, including export rebates and subsidies, cheap loans and investment grants for exporters; short term measures, such as I.M.F. loans, sale of foreign assets, running down of reserves of foreign currencies; devaluation, which involves a lowering of the exchange value of a currency in terms of other currencies. The necessity to reduce the deficit on current account remains a central problem for the U.K. Government.

G.A.T.T.

The General Agreement on Tariffs and Trade (G.A.T.T.) was signed in 1947. The main provisions of the Agreement include the following:

- (a) Discrimination among member countries is prohibited. Bilateral agreements concerning import duties reductions must be extended to all member states.

- (b) Quantitative restrictions on imports and exports are generally forbidden.
- (c) Customs duties fixed by common agreement may be modified only after consultation with all states concerned.
- (d) Subsidies may be granted only after their potential effect on the interests of all member states has been examined.

EUROPEAN ECONOMIC COMMUNITY

The *Treaty of Rome*, which set up the European Economic Community (E.E.C) was signed in 1957 by France, West Germany, Italy, The Netherlands, Belgium and Luxembourg. The U.K. signed the Treaty of Accession to the European Communities in 1972; U.K. membership of the Common Market—the most significant aspect of E.E.C.—followed. The *European Communities Act* became law in 1972, making the necessary legislative changes called for by exercise of the rights of membership of E.E.C.

Article 2 of the *Treaty of Rome* states that the Community's main task is: "by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and close relations between the States belonging to it."

Article 3 of the Treaty sets out the Community's main activities, which include the following:

- (a) The elimination as between Member States, of customs duties and of quantitative restrictions on imports and exports and of all other measures having equivalent effects;
- (b) The establishment of a common customs tariff;
- (c) The abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital;
- (d) The institution of a system which will ensure that competition in the common market is not distorted;
- (e) The application of procedures for co-ordinating the economic policies of Member States, the approximation of their laws so that the common market may function properly, and the creation of a European Investment Bank and Social Fund.

CHAPTER THIRTY

Exporting

The export of goods from Britain is undertaken by a number of different groups including manufacturers, overseas agents, export merchants, export commission agents, export agents, export associations, importers' buying offices and packing and forwarding agents.

MANUFACTURERS obtain orders from customers abroad and despatch goods direct or through a forwarding agent.

AGENTS AND REPRESENTATIVES in foreign countries obtain orders and supply from local stocks or forward the orders to their principals for supply direct. They are remunerated by a salary, by commission on sales, by profits on goods imported and resold or by a combination of these factors. Stockholding agents may be supplied *firm* (being obliged to pay for the goods after an agreed period of credit, whether they have sold them or not) or *on consignment* (the goods remain the property of the exporter and when they are sold to a customer the agent forwards the purchase price less an agreed commission). An agency may be *exclusive*, when the manufacturer grants the agent the sole right to supply customers in a given market, or *open-market*, when customers may obtain the goods through other channels if they wish. Exclusive agencies may be illegal in some circumstances, particularly in E.E.C. countries; their advantage is that they give the agent a more assured market, their disadvantage that they remove the spur of competition on price, delivery and after-sales service. Larger manufacturers may set up branches, depots or sales offices overseas, which act in much the same manner as agents.

Agents' services may extend to servicing, repair, debt-collection, local advertising, reassembly, repackaging, submission of products to national standards institutions, market research and so on.

EXPORT MERCHANTS (shipping merchants or merchant shippers) supply their customers abroad with goods which they themselves purchase from various manufacturers. They may ship the goods themselves, or instruct agents to do so on their behalf.

EXPORT COMMISSION AGENTS contract to buy goods in the U.K. on behalf of clients abroad and to despatch them in accordance with instructions. They almost invariably describe themselves as "merchants" although they are merely agents. They receive a

commission for their services, and either attend to the shipping themselves or put it in the hands of forwarding agents. They are usually buying agents, and normally do not sell goods on their own behalf, although in some cases they act as selling agents for manufacturers. Most of the exporting from this country passes through the hands of this class of intermediary.

EXPORT AGENTS are individuals or firms who represent one manufacturer or several non-competing manufacturers; usually they receive their orders from export merchants or from export commission agents.

EXPORT ASSOCIATIONS OR GROUP SELLING ORGANISATIONS are associations of allied or complementary manufacturers who combine in order to secure export trade.

IMPORTERS' BUYING OFFICES are offices in the country of export which are maintained by foreign importers for the purpose of buying goods on the spot in accordance with instructions sent to them by their principals.

PACKING, SHIPPING AND FORWARDING AGENTS specialise in packing goods and, from experience, know the best way to pack goods and the most suitable form of packing to use. In addition, these firms must carry out on the exporters' behalf all the formalities connected with the shipping of goods.

GETTING THE ORDER

MANUFACTURERS get their orders from the following sources:

- (1) Their own representatives visiting possible customers abroad.
- (2) Advertising letters and leaflets sent by post.
- (3) Advertisements in home and foreign trade journals.
- (4) Visiting buyers from foreign firms.
- (5) Agents or foreign representatives.
- (6) Export merchants and commission agents.
- (7) Long-standing connections with buyers abroad.

EXPORT MERCHANTS get their orders in much the same way as do manufacturers, but they do not always depend on one line or class of goods. Consequently they have a greater chance of getting business by the recommendation of satisfied customers.

EXPORT COMMISSION AGENTS get their "marks" by recommendation, by personal tours in a certain district, or by advertisements in trade journals circulating overseas. (Foreign importers have a special mark put on the cases containing their goods, and to "get a mark" is a

term often used by commission agents to signify the securing of a new client.)

EXPORT AGENTS, PACKING, SHIPPING AND FORWARDING AGENTS, in so far as they act as exporters on their own account, secure their orders in the same manner as export merchants or manufacturers.

EXPORT ASSOCIATIONS, being combinations of manufacturers, secure their orders through the intermediary of the members of the association if their agreement is to "pool" orders received. Otherwise they obtain the orders in precisely the same way as an individual manufacturer.

IMPORTERS BUYING OFFICES receive from their home offices their instructions to buy and export goods.

DIRECT OR INDIRECT EXPORT

A manufacturer who is about to enter the export trade must decide whether he will enter the foreign market himself as an exporter, or whether he will have his commodities exported through professional exporters of the types already mentioned.

The chief factor entering into the problem of whether the manufacturer shall be his own exporter or shall employ a professional exporter is that each is a specialist in his own sphere. The manufacturer is a specialist in the commodities he manufactures, and to that extent is more conversant with their potentialities than a professional exporter. On the other hand, the professional exporter is more skilled in the methods of his particular market. He has the organisation, capital and experience necessary to ship and to finance his shipments to the market in which he specialises, and often he can do this more easily than the manufacturer could.

INQUIRIES AND QUOTATIONS

An export commission agent is rarely asked to make quotations, since his customer usually relies upon the agent's judgment to secure the goods at the best prices available, but, in the case of direct exports, inquiries and quotations are commonly received and given before an order is secured.

An *inquiry* is a request to be informed of the price at which goods will be sold, or services rendered, while a *quotation* is the reply to an inquiry. Both should contain full details of the goods required, their description, catalogue number or grade, sizes, weights or other distinguishing features, the number or quantity, time and method of delivery, method of packing, and, in the case of a quotation, the

price and terms of sale. It is especially important in foreign trade to make certain that all the necessary information is given, and, where a quotation is based upon an inquiry, it should repeat all the details of the inquiry, together with any further details not contained therein, but which form part of the contract of sale.

In the case of the first inquiry, it is usual to make some investigation of the financial position of the client, either by means of a banker's reference, by means of a trade reference, *i.e.*, inquiry of some firm or firms who have had business dealings with the person in question, or through inquiry agencies.

Inquiries and quotations are frequently made by means of telegrams or cables sent in code. Instructions for the use of the various public codes are to be found in the publications themselves, but exporters frequently have their own private codes specially compiled for their particular businesses, copies of which they supply to their customers. It is the common practice of both exporters and importers to have printed upon all the documents they use in foreign trade the names of the various public codes they habitually use, together with the cable addresses which they have registered with the postal and cable authorities for telegraphic use.

Before making a quotation, an exporter would have to calculate the prices at which he could carry out the shipment. The cost of the goods would be known to a manufacturer, but a professional exporter would have to make his own inquiries from various manufacturers, and thereafter consider which is likely to give the greatest satisfaction to his customer in quality, price and time of delivery. He must also ascertain the costs of packing, delivery to the seaport, warehousing, insurance, marking, inspection (if necessary), shipment, freight, insurance and finance.

Which of these expenses it would be necessary to include in the calculation of the export price would depend upon the terms of delivery called for in the inquiry, and the method to be adopted for financing the transaction.

It may be necessary for the exporter to quote the price in his own currency or in that of his customer, according to the terms of the inquiry and the circumstances of each particular case. Where a quotation is to be made in the foreign currency it will be necessary to calculate through the forward exchange market at what rate of exchange the exporter will be able to sell his foreign exchange when the transaction has been completed.

PRICE QUOTATIONS

In addition to the terms used in connection with purchases and sales

already dealt with in Chapter 10, special terms are used in the quotation of prices in international trade. The following are among the most common:

DELIVERED OR FREE DOCKS is occasionally met with in cases where the inquiry relates to goods which are to be exported. The charges of unloading (if any) and delivery to the docks at the port of departure are included but dock dues, wharfage and portage are not.

F.A.S. (FREE ALONGSIDE SHIP) means that the goods are delivered to the side of the ship, but that any charges for loading on to the ship are extras.

F.O.R. (FREE ON RAIL) and **F.O.T. (FREE ON TRUCKS)** cover all costs up to and including loading on rail. The buyer pays all subsequent costs, including railway and other transport charges.

F.O.B. (FREE ON BOARD) includes the cost of loading the goods on to the ship. It is the duty of the seller here to secure from the shipping company some form of receipt for the goods, and to hand this to the buyer. Such a quotation usually names the port, e.g., "F.O.B., Glasgow", but if it reads, e.g., "F.O.B., English Port", the buyer has the option of naming the port of delivery.

C. & F. (COST AND FREIGHT) signifies that the *freight* will be paid by the seller and that he will secure the necessary bills of lading. Such a quotation must include the name of the port at which delivery will take place, e.g., "C. & F., Calcutta".

C.I.F. (COST, INSURANCE AND FREIGHT) includes freight as well as the cost of *insurance* over the risks commonly insured against in the particular trade. Such insurance will not usually include exceptional risks, e.g., war risk. It is the duty of the seller who quotes C.I.F. prices to pay the premium for the insurance and to secure the relative insurance *policy* or *certificate*. The port to which the charges are paid must be named.

C.I.F.I. (COST, INSURANCE, FREIGHT AND INTEREST) is occasionally met with, and additionally to freight and insurance includes *interest* on the value of the shipment. C.I.F.I. quotations are made, for instance, by agent acting for an importer, and sometimes the agent's *commission* is added, thus, "C.I.F.C.I." (i.e., Cost, Insurance, Freight, Commission and Interest).

C.I.F. & E. ("E" standing for "EXCHANGE") signifies a C.I.F. quotation which includes also the risk of exchange fluctuations; sometimes it is used for the inclusion of the banker's charges.

EX SHIP means that the seller will pay all expenses up to the time the goods arrive at the port of discharge, but that the buyer must bear the cost of taking delivery *from the ship*.

LANDED signifies that the seller pays all expenses on the goods up to the point of discharge, including those involved in landing them from the ship at the named port.

IN BOND means that delivery is to be made into a customs bonded warehouse at the named port, but that any charges for withdrawal therefrom have to be borne by the buyer.

DUTY PAID includes the import duty, and may or may not include the charges for warehousing to the date of withdrawal.

FRANCO, RENDU OR FREE means that all charges for delivery to the buyer's warehouse are included in the quotation.

TERMS OF PAYMENT

These, too, enter into the calculation of prices in foreign trade. An exporter who is an agent or merchant would meet not only with the terms of payment which were explained in Chapter 10, but also with the following:

C.W.O. (CASH WITH ORDER) and C.O.D. (CASH ON DELIVERY) are occasionally used in first transactions, or where single articles of small value are exported. Under C.O.D. terms payment is usually secured by sending the *relative documents of title*, or, in the case of postal despatches, the goods themselves, through a bank, or by sending the actual goods by postal C.O.D. service. In either case, delivery is made only on payment of the invoice amount.

DRAFT TERMS include all conditions of sale involving the drawing of a draft by the exporter. Such conditions stipulate usually that the documents of title to the goods shall be delivered to the importer either against acceptance (D/A) or against payment (D/P) of the relative bills of exchange.

THE ORDER OR INDENT

The next stage in exporting procedure is marked by the importer's acceptance of a quotation, and takes the form either of an *order* or of an *indent*, which is forwarded by telegraph, cable or mail to the seller or to the importer's buying agent. This contains the importer's instructions concerning the goods to be exported, gives full particulars with regard to size, quality, shipment required, etc., and also states the price the importer is willing to pay.

SPECIMEN INDENT

Indent No A. 416

94 Smith Street,
Bombay,
India

24th March 19..

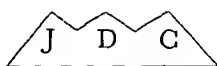
James Hands & Co, Ltd,
Leadenhall Street,
London, E.C. 3

Dear Sirs,

Kindly purchase and ship on our account the under-noted goods, or as many of them as possible:

DELIVERY *C.i.f. Bombay.*PAYMENT *Draw at 10 d/s D/A through Bank of India, Bombay.*SHIP *By first available steamer.*

MARK

*Bombay*

201—upwards.

Yours faithfully,
JOHN DAWSON & CO
per M. Simes

NO OR QUANTITY	DESCRIPTION	PRICE OR QUALITY	REMARKS
6 doz.	Ajax cycles	Half 'A' quality Half 'B' quality	Transfers on frame "John Dawson & Co, Bombay"
12	Motor Cycles (3 each Minerva, Roadie, Rex and Jester)	Various prices in each make	Transfers as above
$\frac{1}{2}$ gross	Cycle pumps—hand	Medium quality	
3 doz.	Cycle pumps—foot	" "	

NOTES

- (1) Indents are numbered just as order forms are numbered, and for the same reason.
- (2) "Or as many of them as possible." Some such phrase as this is often inserted

to indicate that the buyers will not refuse to accept a portion of the goods if the order is incomplete.

- (3) The delivery date and shipping time are mentioned by the buyer to ensure his getting the goods in time for a seasonal sale time.
- (4) Payment at 10 d/s means that the buyers will pay the amount of the bill of exchange drawn on them by the agent, not later than 10 days after it is presented to them. D/A (*Documents against Acceptance*) means that the documents of title to the goods must be delivered to the importers against acceptance of the bill of exchange. Similarly D/P means *Documents against Payment*.
- (5) Part of the above indent is *closed*; that is, it is an order for specific goods. Part is *open* and merely indicates classes of goods and qualities. In the first case the agents simply give the orders and instructions to the firms concerned. In the second case their buyers must select and buy for the Bombay firm.
- (6) Goods sent by ship do not have the name and address of the importer marked upon them, but bear some distinguishing mark, number and port mark. The object of this is to facilitate unloading, completion of Customs entries in various ports, and to ensure secrecy to the importer.

DEALING WITH THE ORDER

The indent is acknowledged and then sorted in the exporter's offices; that is to say, it is divided into the various classes of goods, and for "open" lines a decision is made as to the exact articles to be ordered, and the firms to which the orders shall go. As soon as these details are settled, and a particular ship has been decided upon, all the particulars are entered in the "shipping book".

PACKING AND MARKING

Packing may be undertaken by the manufacturer or by a firm of packing agents. It is an extremely important part of the exporting procedure and should receive careful attention. Any instructions given by the importer must be strictly observed, or, where no instructions are given, the custom of the particular market and the local important regulations for that class of goods must be followed. To facilitate handling, the packs must not be bulky. Also the freight charged may be based upon the measurement of the consignment, and in this case the maximum quantity of goods, consistent with safety, must be packed in the minimum of space.

If the goods are not uniform in size and shape, they should be put together in the warehouse as compactly as possible in the position in which it is suggested they should be packed. The packer will then arrange for cases or bales of appropriate measurements to be made.

A distinctive mark and number, together with the port of destination, should be marked on each pack by means of a stencil.





The measurements should also be marked on the outside, and in some cases the gross weight, tare and net weight should be included. The use of a distinctive mark for each class of goods is of great advantage in facilitating the storing of goods on arrival, and this usually consists of some simple geometric figure which may include the initials of the importing firm and the number of the indent.

SHIPPING THE GOODS

When the goods are ready for delivery the exporters make arrangements with the shipping company to reserve space for the goods—an important matter when trade is brisk—and send shipping instructions to the various manufacturers or merchants from whom the goods are being obtained.

If the exporter of the goods resides inland, the actual shipping will be carried out on his behalf by a shipping agent to whom an *advice note* is sent containing particulars of the goods, name of steamer or ship, destination, measurements or weight and value of the goods.

SHIPPING NOTE AND DOCK RECEIPT

Leadenhall Street E.C. 3 25th June, 19..							
No J.174 <i>West India Dock</i> s.s. 'CENTURION' <i>for Bombay</i> <i>John Dawson & Co</i>  <i>Bombay</i>	No J.174 To the Superintendent, <i>West India Dock</i> Please receive the undernoted cases and ship by s.s. 'CENTURION' for Bombay All charges to our account JAMES HANDS & CO LTD <i>John Smith</i> Manager						
o/117167 <i>Received</i>	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 30%;">MARK AND NOS</th> <th style="width: 30%;">PARTICULARS</th> <th style="width: 40%;">REMARKS</th> </tr> </thead> <tbody> <tr> <td style="text-align: center; padding: 10px;">  </td> <td style="padding: 10px;"> <i>One (1)</i> <i>Case Cycle</i> <i>Accessories</i> </td> <td style="padding: 10px;"> <i>Part of</i> <i>Consignment to</i> <i>same mark</i> <i>Overall</i> <i>measurements</i> <i>1.2 x 1.8 x</i> <i>0.5 m</i> </td> </tr> </tbody> </table> <div style="display: flex; justify-content: space-between; margin-top: 10px;"> <i>Bombay</i> </div>	MARK AND NOS	PARTICULARS	REMARKS		<i>One (1)</i> <i>Case Cycle</i> <i>Accessories</i>	<i>Part of</i> <i>Consignment to</i> <i>same mark</i> <i>Overall</i> <i>measurements</i> <i>1.2 x 1.8 x</i> <i>0.5 m</i>
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NOTES

- (1) The counterfoil is retained by the exporter as his record of the note that has been sent. Perhaps a better method is to have the shipping note made in actual duplicate by means of a carbon copy, as this avoids the possibility of any difference between the counterfoil and the note itself. The carbon copy is similar in form to that given above, except that, in place of the words "Please receive" is printed the word "Received". The object of this is to enable it to be presented by the delivering carman to the Dock authorities for signature, after which the document becomes a *dock receipt*.
- (2) The exporters send in the shipping note because they effect actual delivery of the cycle accessories at the docks themselves. In the case of goods consigned through to the docks (e.g., the cycles ordered in Coventry), British Rail would be responsible for delivery and would make out the shipping note and obtain the dock receipt.
- (3) Sometimes a shipping company will not accept goods for shipment unless the shipping note is "backed". This happens when there is great pressure on the carrying space, and there is a possibility that goods may be delivered for shipment which simply cannot be loaded, and will have to remain on the dock. To avoid this the shipping company informs shippers that all shipping notes must be submitted to them before goods are sent to dock. If the vessel is not yet full, they indorse the shipping note on the back ("backing"); if all its space is arranged for, the shipper is told so and does not deliver his goods to the dock.

About the same time as the shipping instructions are sent out, the exporters may deliver to the dock certain of the other goods which have been bought by them in London and which they have unpacked, inspected and repacked. With the goods they send a *shipping note* (or *shipping order*). As regards those goods which the suppliers pack and deliver to the dock, the shipping note would be prepared and delivered by the suppliers.

DOCK RECEIPTS AND MATE'S RECEIPTS

Goods may be delivered to a ship either directly, from the quay or from a lighter or barge or through a dock company or warehouse.

When delivery is made to the dock, a *dock receipt* or *wharfinger's receipt* is received but when the goods are delivered direct to the ship, the shippers obtain a *mate's receipt*, which is a receipt for the goods signed by or for the mate (chief officer) of the ship. Each of these documents constitutes a receipt for the goods and is eventually exchanged for a bill of lading.

SECURING THE BILLS OF LADING

Before the goods have all been delivered to the docks the exporter

prepares the necessary documents (*bills of lading* and *invoices*), and insures the goods against maritime and other risks in transit.

The *bill of lading* is a document wherein the steamship company gives its official receipt for goods shipped in one of its vessels, and at the same time contracts to carry them to the port of destination. It is also a document of title to the goods and, as such, is freely transferred by indorsement and delivery. *A bill of lading is not, however, a fully negotiable instrument.*

Bills of lading are prepared for each consignment, usually in a set of three identical bills, each bearing reference to the others. These, known as the *parts* of the set, are signed. In addition two unsigned *copies* are made out. The exporter fills in the particulars of the goods, marks, destination, name of ship and so forth, and lodges the bills at the shipping company's offices together with the dock receipts (or mate's receipts, as the case may be). The shipping company makes out a *freight note* (invoice of the charge for carrying the goods) and forwards it to the exporter. As soon as the freight charges are paid, or payment thereof otherwise satisfactorily arranged for, the bills of lading are checked and signed by an authorised clerk on behalf of the master of the vessel, and the shipping company returns the receipted freight note, together with the signed bills of lading, to the exporter. Very often the bills of lading are sent with the freight note, and the charges for freight are paid later, but a shipping company will take this course only with a shipper who is well known to them.

A signed part conveys the title to the goods, and, since one of them must reach the consignee before he can claim the goods to which they relate, it is customary to send at least two and sometimes three *parts* by different air-mails, so that if one, or even two, are lost, there is still a third to rely on. One *copy* is usually retained by the exporter and one by the master of the ship, for purposes of record. These are usually overprinted with the word "copy".

When goods are sold under a contract whereby the importer agrees to pay freight—this is most common with raw materials and commodities subject to pilferage—the bills of lading will be sent forward to the importer marked "freight forward", but this can be done only by agreement with the shipping company. When the goods in such a case arrive at their destination, the importer presents the bill of lading to the shipping agent, who passes him a freight note and, on payment of the freight, stamps the bills of lading with a freight release, or alternatively exchanges the bill of lading for a separate document termed a freight release.

A bill of lading signed without any qualifying clause is called a "clean" bill of lading, and is taken as proof that the relative goods—or at least the cases—were in good condition when loaded. If, however,

the document bears words such as "two sacks broken", or "one case damaged", the bill of lading is a *foul* or *claused* bill. Such a bill of lading is of restricted value as security or as evidence of shipment. If the importer is inclined to take any opportunity of refusing delivery or of making claims for damage, such a foul bill of lading generally results in dispute leading to litigation or reference to arbitration. In order to avoid this the exporter usually endeavours to persuade the shipping company to accept a *letter of indemnity*, which is a letter addressed by the exporter to the shipping company, agreeing, in return for clean bills of lading, to indemnify the company for any claim on the part of the importer in respect of the goods. If fundamental defects are known to the shipper and the shipowner or their agent at the time a clean bill is issued, this amounts to a conspiracy to defraud an assignee for value who may rely on the clean bill. The indemnity is thus tainted with fraud and is unenforceable in an English Court.

Bills of lading are clearly most important documents, as the master of the vessel will hand over the goods only to the persons named in them, or to any other person to whom they may be indorsed. When a bill of lading is made out in favour of a named person "or his order or assigns", or simply "to order", it cannot be effectively transferred without indorsement.

FORMS OF BILL OF LADING

A bill of lading contains a long list of exceptions and conditions. It serves three purposes:

- (1) It is a *quasi-negotiable document of title* to the goods.
- (2) It *acknowledges receipt* of goods on board.
- (3) It is *evidence of the terms of the contract* of affreightment between the shipper and shipowner.

In 1921, following an international conference at the Hague, a standard set of clauses for bills of lading was drawn up for use as an international code. *The Hague Rules*, as they are called, set out the rights, responsibilities and liabilities of the carrier in respect of goods whilst on board his vessel, and thus are complete in themselves. If a bill of lading contains a provision incorporating the Hague Rules, then the whole of those rules apply as if they were each set out in the bills of lading.

The Hague Rules were given statutory effect by the *Carriage of Goods by Sea Act* 1924, in which they are reproduced as a schedule. By this Act, all goods carried by sea under a bill of lading *from* any port in Britain or Northern Ireland are carried subject to the provisions of

the Act which forms the basis of the liability of a sea-carrier. In accordance with this Act, every bill of lading issued in respect of such shipments must incorporate, as part of its terms, the Rules scheduled in the Act, which amount, in effect, to a series of standard clauses. These Rules impose on the carrier certain responsibilities and liabilities in relation to the loading, handling, storage, carriage, custody, care and discharge of the goods, and, at the same time, they entitle the carrier to certain immunities.

SHIP'S MANIFEST

Full details of all bills of lading are entered in the ship's manifest, a document prepared and signed by the master which contains particulars of all cargo, stores and dutiable articles carried on board. The manifest is required to be produced to the port authorities, the customs officials and Commercial Consular staff on demand.

CHARTER PARTY

Where a shipowner lets a ship or some part of its carrying capacity for the conveyance of goods for a particular voyage or for a specific period, such an agreement is termed a *charter party*. The ship usually remains in the possession, and under the control of, the charterer for the specified voyage or time. The particular port at which the ship is to discharge may not be stated in the charter party, this being disclosed later.

Charter parties are of several kinds, but usually fall into one of two classes: (a) *voyage charters* and (b) *time charters*.

A *voyage charter* is one under which a ship is hired for one or more voyages, whilst a *time charter* is one providing for the hire of a ship for a specified time.

There are many well-defined forms of charter party used in various trades, but all voyage charters provide, *inter alia*, as follows:

- (1) The shipowner undertakes that the ship is in a seaworthy condition, and that it shall be available and ready at the port of shipment at a certain time.
- (2) The charterer agrees to load a specified amount of cargo on the ship, and to pay freight on an agreed tonnage.
- (3) Provision is made for days to be allowed for loading and unloading, known as *lay days*, and for the payment by the charterer of *demurrage* for days in excess of that period, or payment by the shipowner of *despatch money* for lay days not used.

Dead Freight. Freight is usually calculated at so much per ton, and if the ship is not fully loaded, the difference between the freight for the actual cargo shipped and the total freight which must be paid is referred to as "dead freight".

INSURING THE GOODS

Before the goods are despatched, they should be insured against sea perils. The main features of marine insurance are discussed in Chapter 20; here we note that there are two main classes, differing in the amount of "cover", or protection, they give:

- (1) WITH PARTICULAR AVERAGE (W.A.), which covers not only total and general average loss, but also partial loss or injury to the particular consignment suffered in transit, which is not by way of general average. "Average" in this connection signifies partial loss.
- (2) FREE OF PARTICULAR AVERAGE (F.P.A.), which insures against total loss, general average loss and specified particular average loss only.

The *policy* is a document setting out the contract for insuring the goods. Marine policies can be made out in favour of one person or firm, and by simple indorsement and delivery may be assigned to another.

There is one other term in marine insurance which must be understood. Suppose a ship encountered difficulties during its voyage, and, for the general safety of the crew, cargo and ship, the captain was forced to lighten the ship by casting over (*jettisoning*) cargo, or that he had to employ another vessel to tow him into port. In such a case the cost of the action thus taken to save the ship is a *general average* sacrifice and must be shared proportionately by all the parties concerned, *i.e.*, by the owners of the cargo, ship and freight, or by their respective underwriters. There is a long list of such possible risks, and they all come under general average, whether the loss is to the ship, to the cargo, or to the freight at risk.

Having secured the policy, the exporters can send either the document itself or a duplicate to the consignee, and charge the amount of the premium in their invoice.

INVOICE


Cable Address: Handcuff, London
 Codes Used: A.B.C. (6th Ed.), Lieber's
 & Private

LEADENHALL STREET,
 LONDON, E.C. 3
 27th June, 19..

MESSRS JOHN DAWSON & CO

Bought of JAMES HANDS & CO, LTD,
 Export Commission Agents

Goods shipped per s.s. *Centurion of Harrison Line* on 26th June, 19..

MARK	QUANT.	DESCRIPTION		£
 BOMBAY 201-212	} (72)	18 Cycles Qual. A	£65	2340.00
Cases Nos 12 201-212		18 Cycles Qual. B	£55	1980.00
				4320.00
Commission @ 2½%				108.00
Freight and primage				4428.00
12 cases				400.00
B./L. 30 p. Transport and Dock Charges £66.00				60.00
Insurance £2,400 @ 0.55%				66.30
				23.76
				4978.06

Drawn at 10 d/s through the Bank of India Ltd
 E. & O.E.

18

NOTES

- (1) *Primage* is a customary charge, usually of an approximate percentage on the freight, made by shipowners on all cargo.
- (2) *Freight* is usually calculated per ton, per package, or *ad valorem* (according to value).
- (3) "12 cases." This is the cost of the cases containing the goods.
- (4) "B./L. 30p", represents the charge for the B./L. forms.
- (5) *Insurance* is calculated on the value of the goods. In some cases the exporter is instructed to insure for 10 per cent anticipated profit.

- (6) *Commission* at an agreed rate on the invoice price of the goods.
 (7) "*Drawn at*", etc. This information is given to show the importer whence to anticipate the exporter's draft and the documents covering the goods. The manner in which payment shall be made is a matter for agreement between the parties.

(The items to be included in the invoice will, of course, depend upon the terms on which the goods have been sold, e.g., C.I.F., F.O.B.)

INSURANCE CLAIMS

In case of any claim made under a marine insurance policy the following documents are necessary:

<i>Total Loss</i>	<i>Particular Average Loss</i>
Bill of Lading	Bill of Lading
Captain's Protest	Captain's Protest
Insurance Policy	Insurance Policy
Subrogation of rights in the insured goods	Certificate of Survey
	Certified Account Sales, if the goods are sold

CAPTAIN'S PROTEST (or Ship's Protest) is the sworn statement of the captain giving particulars of the loss and the cause of it.

CERTIFICATE OF SURVEY is given by the Lloyd's surveyor or other marine surveyor who surveys the goods and assesses the damage.

CERTIFIED ACCOUNT SALES shows how much is eventually obtained for the goods if they have been sold.

PREPARING THE INVOICE

The invoice for the goods is made out in triplicate, in quadruplicate or in greater number as may be required, one to go with each executed bill of lading. A typical invoice is shown on the previous page, the Notes below refer to it.

CERTIFICATES AND DECLARATIONS OF ORIGIN

The European Economic Community (E.E.C.) makes use of declarations of origin to ascertain the origin of its imports. The purpose is to ensure that the appropriate duty is levied on merchandise and that no evasion takes place by means of routeing consignments through countries enjoying a preferential tariff. The exporter declares and certifies the origin of the goods on an official form.

CONSULAR INVOICES

In many countries *ad valorem* import duties are charged and, in order to avoid incorrect returns, it is required that the importer shall present an invoice containing the F.O.B. prices and shipping charges, duly certified as to correctness by the Consul of the importing country stationed in the exporting country. A special form is required, and the exporter or his agent has to certify the accuracy of the prices given, after which the Consul appends his signature in return for a prescribed fee. One or more copies are retained by the Consul, one being forwarded to the customs authorities in the port of destination. The other copy (or copies) is handed to the exporter, who forwards it to the importer with the other documents.

PRE-ENTRY AND ENTRY

Goods for export are either entered or pre-entered to customs, according to their nature or origin. Generally, goods subject to special restrictions, duties or rebates are required to be pre-entered, *i.e.*, entered to customs for clearance before export is permitted. Goods from a bonded warehouse on which duty has not been paid, transit goods, drawback goods (*i.e.*, goods on which duty paid is to be refunded on export) and goods to be charged with duty of any kind must be pre-entered. Explosives, and categories of goods the customs decide to require pre-entry for (at present goods requiring export licence) must be pre-entered. All other goods must be entered to customs within six days after export.

In general, goods are *pre-entered* on a shipping bill, a customs form calling for detailed particulars of the goods and *entry* is required on a *specification*, a similar but not so detailed form.

SECURING PAYMENT

When the shipment has been despatched, the exporter takes steps to reimburse himself for his outlay and commission. This he does under the conditions of the order by drawing a *bill of exchange* (see Chapter 33) either on the importer or upon some bank with whom the importer has made suitable arrangements. There are three main methods by which the exporter may finally secure payment, under draft terms, each of which will be considered in turn.

First, the exporter (say to Australia) can draw a draft on the importer, ordering payment to be made to the exporter's order or to his bank, attach to the draft the bill of lading, marine insurance

policy, invoice, and certificate of origin, endorse the first three in favour of his bank (there is no need to endorse the draft if it is made payable to the bank), and hand the *documentary draft* to his bank for collection. The bank will forward the whole to their branch or agents in Adelaide (endorsing all necessary documents), who will present them to the importer, and the draft (or *acceptance*, as it is now called) will be retained until it matures for payment. Alternatively, if the credit of the importer is not assured, the documents may be handed over only on payment of the bill. Upon maturity of the draft it will be re-presented and the funds received will be entered to the credit of the exporter's bank which will then credit the account of the exporter. The documentary draft would be handed to the London Office of the exporter's bank.

Had he desired to secure his funds earlier, the exporter could have asked an Australian bank to discount his draft; he would then be asked to sign a *letter of hypothecation*. This is a letter addressed to a bank, detailing a draft or drafts relating to a shipment of goods. In the event of the dishonour of the draft the bank is authorised to sell the goods in order to reimburse itself for the amount advanced to the exporter in discounting the draft. Provision is made in the letter of hypothecation for the adjustment of any balance owing to or from the bank, representing the difference between the face value of the bill and the proceeds of the sale of the goods, less the expenses thereof. The effect of the letter is to give the banker a charge on the goods and their proceeds.

The procedure with regard to presentation and payment of the bill would be the same as in the previous case, except that the proceeds of the bill would not be credited to the exporter, he having already been paid when his bill was discounted. This method would most probably be followed in the example given.

It is a common practice nowadays for exporters to require importers to provide them with a *letter of credit*, the purpose of which is that the exporter shall be able to draw his draft upon a bank. In such a case the importer will request his bank to issue to its agent or branch in the exporter's country a letter of credit requesting the agent or branch to accept the exporter's draft drawn against a stated shipment. The letter of credit states the usance of the bill, a maximum amount, the period within which it must be drawn, and the documents which must accompany it. The bank issuing the credit will give the importer a letter, addressed to the exporter, authorising the exporter to draw such a draft, and repeating the stipulations referred to above. This letter of credit may contain words implying a guarantee that the agent bank *will* accept and pay the bills upon due presentation. It may also state that the draft must contain a reference

to the number of the credit under which it is drawn. In such a case the exporter will attach the credit to his draft and present the whole to his own bank for discount. The exporter's bank will present the draft for acceptance by the bank upon which it is drawn and hand over all the documents in return for acceptance or payment, according to the circumstances of the transaction.

COMPLETING THE TRANSACTION

All that remains is for the exporter to write to his customer in Adelaide, informing him of the shipment of the goods and the drawing of the draft, and enclosing a copy of the invoice for his information. Finally, the exporter would have to settle the accounts of his suppliers and those for insurance, freight, dock charges and cartage.

It should be understood that the above explanations are purely illustrative. Many orders are settled without the use of bills of exchange, in which case the shipping documents will probably be sent direct to the importer; or the exporter may hand them to his banker with the request to send them to his correspondent to be presented to the importer in exchange for the invoice amount.

CARRIAGE BY AIR

AIR FREIGHT AGENT

Exporters may approach the airline direct or go to an air freight or forwarding agent (this is the commoner practice).

The agent is in touch with the freight market and can recommend the best transport for a given cargo. He will handle the goods and the documents and may be able to arrange air groupage, *i.e.*, carrying the goods with others for the same destination at a bulk rate. His insurance normally covers the goods from the factory and cover begins with advice to the agent, without formality. The exporter may make independent arrangements for insurance if he wishes.

An exporter using an agent completes an *Agent's Advice Note* giving full particulars of the cargo. This is sent with the commercial invoices and any export licence to the agent. The goods are then sent to the agent's warehouse or to his office at the airport if he has one. It is his responsibility to prepare the consular invoices and air consignment note and the customs entry. Many countries, however, have dispensed with the need for consular invoices in the case of air freight, owing to the impossibility of getting them to the port of destination by the time the goods arrive.

AIR CONSIGNMENT NOTE (OR AIR WAYBILL)

The *Consignor* is required to make out an air consignment note in triplicate, which must be lodged with the merchandise. The parts are marked:

- (a) "For the Carrier";
- (b) "For the Consignee";
- (c) "For the Consignor".

The first is signed by the consignor and retained by the carrier for manifest purposes. The second is signed by the consignor before lodgment; it is signed by the carrier on acceptance of the cargo, and accompanies the goods (as "in the ship's bag" for a bill of lading). The third is signed by the carrier and returned to the consignor. It is not unusual for copies (as distinct from signed parts) to be made out for statistical or filing purposes. When there is more than one package, the carrier can require the consignor to make out separate consignment notes.

The note must be printed in one of the official languages of the country of departure (*e.g.*, French or Flemish in Belgium) and also in either English, French or German. Other translations may be included.

The following details must be indelibly inserted by the consignor:

- (a) place and date of completion;
- (b) departure and destination;
- (c) name and address of consignor and consignee;
- (d) number of packages, marks, etc.;
- (e) nature of goods, weights, quantities, etc.;
- (f) party liable for freight and customs;
- (g) if for payment on delivery, price and collectible expenses;
- (h) where required for certain insurance purposes, the value declared;
- (i) the number of parts of the note;
- (j) list of documents attached, *e.g.*, for customs purposes;
- (k) route and time limit arranged;
- (l) value for customs purposes.

The carrier *may* insert, or require to be inserted, reference to the apparent condition, packing, etc. (corresponding to "good order and condition" or—conversely—"clausing" of a bill of lading).

The carrier *must* insert:

- (a) name of first carrier accepting the consignment for carriage;
- (b) freight agreed and expenses; date and place of payment;

- (c) agreed stopping places;
- (d) a statement that the carriage is subject to the rules relating to liability set out in the *Warsaw Convention*, held in 1929 for the unification of certain rules relating to the international carriage of goods by air. See also *Carriage by Air and Road Act 1979*.

Whereas the consignor is supposed to make out the note in the first instance, in practice it is often made out by the carrier or the agent: the agent, drawing commission from the carrier, is not *prima facie* the agent of the consignor. Nevertheless, when the carrier or the agent makes out the note he is normally deemed to have done so for and on behalf of the consignor. Also, if the note is incomplete in some detail the carrier is entitled to complete it to the best of his ability.

EXPORT CREDITS INSURANCE

The Exports Credit Guarantee Scheme, operated by the Exports Credit Guarantee Department (E.C.G.D.), an independent department responsible to the Secretary of State for Trade, with a head office in London and 12 regional offices, assists exporters by providing insurance against the risks that overseas buyers will be insolvent (the Credit Risk) and that effective currency will not be available to buyers with which to pay for the goods (Transfer Risk). See *Export Guarantees and Overseas Investment Act 1978*, which consolidates the *Export Guarantees Act 1975*, and ss. 1 and 2 of the *Overseas Investment and Export Guarantees Act 1972*. The 1978 Act empowers the Secretary of State to give guarantees in connection with the export, manufacture, treatment or distribution of goods to persons carrying on business in the U.K. and enables him to give such guarantees as are expedient in the national interest.

The Department offers four main types of cover: short-term policies, quasi-capital goods guarantees, medium-term policies and guarantees to banks.

Short-term policies are the most numerous. They are designed to deal with Credit and Transfer Risks in connection with consumer goods.

The principal policies are the Comprehensive Guarantee and the Comprehensive Guarantee (Shipments). The Shipments policy covers the goods after shipment and the other policy extends to the pre-shipment risk; and the Comprehensive Guarantee covers also the risk of cancellation or non-renewal of an export licence or the imposition of a restriction on the export of goods not previously subject to licence.

Both policies cover the buyer's insolvency, failure to pay for delivered and accepted goods within six months, failure to accept

goods, exchange restrictions, import restrictions, war and civic disturbance, diversion of voyage, other cause of loss abroad outside control of buyer and seller, and the failure of a Government to honour its contract.

The cover guaranteed to the exporter is: (1) on commercial risks—insolvency or default, 90 per cent of the contract price; (2) on political risks, 95 per cent.

PROCEDURE. The exporter makes to the Department: a monthly declaration of contracts entered into and shipments made, with totals for each country; a monthly declaration of debts which have become overdue for a period of three months or longer; application, when necessary, for approval of credit limits on buyers to whom the exporter proposes to give credit exceeding a sum named in the policy.

CLAIMS. Claims become payable in respect of:

- (1) *Insolvency or default.* Immediately after insolvency has occurred, or six months after the due date of payment of the debt, if by that time the insolvency of the debtor, as defined by the policy, has not been established.
- (2) *Non-acceptance of goods.* One month after disposal of the goods.
- (3) *All other risks.* Four months after the due date of the debt, or the occurrence of the event which is the cause of the loss.

Quasi-capital goods guarantees involve goods which, though standard production goods such as lorries and tractors, are normally paid for over periods from above 6 months to 3 years.

Medium-term policies for capital goods are issued for periods of from 2 to 5 years. They are usually written specially for each transaction and do not fit into the general pattern of a standard policy.

Guarantees to banks are made to assist the foreign buyer to obtain loans from the bank.

In Britain and the United States, much valuable assistance in relation to the provision of export credit has been rendered by private organisations, called *Credit Insurance Companies*. These institutions guarantee or undertake responsibility for the due fulfilment of purchase contracts by overseas importers, and so enable exporters to accept orders from buyers on whose credit they could not otherwise rely.

CHAPTER THIRTY-ONE

Importing

Import trade, like export trade, may be direct or indirect. While some manufacturers import their own raw materials, the bulk of imports into Britain are made indirectly through professional importers. There are two main reasons for this. First, the majority of the imports are *raw materials and foodstuffs*, the marketing of which requires such highly technical equipment and specialised marketing organisation that it has long been the custom for these goods to be imported through the intermediary of middlemen who have the necessary knowledge and experience. Then, in the case of many *manufactured* imports, the foreign manufacturer extends his activities to the British market by opening branch selling offices or by appointing sole import agents in the country.

IMPORTS AGAINST ORDERS AND ON CONSIGNMENT

GOODS AGAINST ORDERS. Imports which enter Britain against orders will have been sent in response to precise instructions forwarded to the exporter abroad by a correspondent in this country. Such instructions will specify clearly the type of goods required, their quality and price, the mode of packing and shipping, the approximate time for shipment, and the port to which they are to be consigned.

GOODS ON CONSIGNMENT. These are goods sent by an individual or firm in one country to an agent in another country, with the intention that the latter shall sell them as well as he can and remit the proceeds, less his costs and commission, to the sender. The goods do not become the property of the agent, and his only interest in them is that he is employed to arrange the sale and to account for it to the foreign owner.

By receiving goods "on consignment" a consignee incurs no liability other than the obligation to exercise reasonable care in their storage and sale, and to remit the net proceeds, less his charges and commission, to the consignor.

Consignment business is more common in import trade, and especially in fruit and raw materials, than in export trade and in manufactured goods. There are several reasons for this. For raw materials there is a steady demand, providing employment for brokers and other intermediaries who arrange their sale at the produce markets on foreign account, and who are always prepared to

deal in the commodities concerned. Such is the reputation and connection built up by these import merchants, and so efficient is the organisation of produce markets, that many foreign exporters are induced to ship their goods on consignment, in preference to arranging their own direct facilities for import and sale.

Manufactured goods, on the other hand, which are dependent upon changing fashion and fluctuating demand, and for which there is not such an assured market, do not lend themselves to similar treatment, and it is usual, therefore, for such goods to be marketed direct through actual agents or branches of the foreign exporting house. Moreover, the lack of reliable importers in some foreign markets has prevented manufacturers from sending their goods on consignment. There are, however, occasions when a manufacturer is willing to send a consignment in the nature of a sample shipment to a reliable agent abroad, usually drawing upon the agent for part, at least, of its value.

PROCEDURE ON IMPORTING


Whether the goods are imported on consignment or against orders, the procedure is much the same. In either case, the sender of the goods (the exporter) is known as the *consignor*, and the recipient (the importer or selling agent) as the *consignee*.

The first stage of the transaction in the importing country is the receipt by the consignee of *advice of shipment* from the consignor. With this would come also the bill of lading, insurance policy, invoice and possibly also a weight note relating to the goods.

PRO FORMA INVOICE

To Messrs M. Field & Co, 44 Mincing Lane, London, E.C.3

INVOICE of 50 Pkgs Crepe Rubber shipped per
S.S. *Mandala* for London, consigned to Order,
for sale and account and risk of the
undersigned

		Each		Nett kg		
		50 kg	2500	50p kg		
	50 Pkgs Rubber					£1250.00
	Shipping Charges					60.00
	Freight					80.00
1-50	LONDON Insurance covered in Singapore					

£1390.00

16 Dec., 19..

Lefrère & Co, Singapore

If the goods are shipped on consignment, the invoice would be *pro forma*, that is to say, "for form's sake", and would simply serve to show what the shipper had paid in respect of the goods by way of cost and charges, or what he hoped or expected to receive for the goods (see illustration). Such an invoice, unlike an ordinary invoice, does not amount to a charge note for the goods.

SATISFYING THE CUSTOMS AUTHORITIES

Apart from satisfying the shipping company as to his right to receive the goods, the importer must carefully conform with import restrictions and with customs formalities relative to the entry of all goods into Britain. Unless these requirements are duly complied with, possession of the goods may not be obtained even though the importer can secure their release from the shipowner.

The British customs organisation is regulated by the *Customs Consolidation Act* 1876, subsequent Finance Acts and other special Acts.

These Acts prescribe, in what is known as an *import list* or *tariff*, the duties which must be paid on certain classes of goods imported from abroad, together with the methods of collection, and the various formalities to be observed by persons exporting or importing goods, and by ships entering or leaving ports in the United Kingdom.

SHIP'S REPORT

As the first step in their supervision of goods entering this country from abroad, the customs authorities require the master of every ship (other than a ship engaged in the coasting trade), within twenty-four hours of its arrival in a British port, to deliver to the local customs authorities what is known as a *ship's report*, specifying the name of the ship, the port of registration and nationality, the port whence the ship has arrived, the name of the master and details of the crew, passengers and cargo.

No goods may be unloaded until this report has been delivered and, if it proves to be false, or to contain a false statement, the master is liable to a penalty.

If it is the intention to unload goods at more than one port in the British Isles, separate reports for each landing must be furnished.

Details of all dutiable stores belonging to the ship, master or the crew must also be given, otherwise any goods not so reported are liable to be seized by the customs officials.

ENTRY BY IMPORTERS

The second step in customs supervision is the requirement that every importer of any goods brought into the country, or his agent, must furnish to the customs officials a declaration known as an *entry* which must describe the goods in prescribed form and in sufficient detail to enable them to be easily identified.

The same entry form is used, whether the goods are imported in a ship, aircraft or even a land vehicle (*e.g.*, over the land frontier from the Republic of Ireland). The term "ship" is to be construed as referring to other means of conveyance where appropriate. The form usually consists of a three-part carbon-interleaved set: the top copy is the Customs accounting copy; the second is used by the Government for statistical purposes; the third is used for purposes such as V.A.T. accounting or exchange control.

Information required on the entry form includes: names of importer, consignor, agent and their addresses; ship's name; port or place of foreign loading and importation; country of origin of goods; tariff code number; total value of goods; description of goods; V.A.T. registration number.

It is important to ensure that the Customs entry and invoices are presented at the earliest possible moment, as goods cannot be released until these are inspected and found to be in order. Goods will normally be landed and stored in bond at the customer's expense after three days of grace have elapsed.

PROCEDURE FOR THE RELEASE OF GOODS

- (1) The importer or his agent must prepare the entry and present it with original or certified true copy invoices at the appropriate customs office.
- (2) The customs officials compare the particulars on this form with the ship's or aircraft's manifest and, if the entries agree, the forms are passed as correct and one copy is handed back to the importer. Any duty payable is due at this stage.
- (3) The importer lodges this copy with the dock or airport authorities, who pass it to the superintendent of the warehouse or dock where the goods are to be cleared.
- (4) As soon as the goods are landed, the section or warehouse foreman gets one of the customs officials in attendance to check the entries against the goods. If they are correct, the officer signs an *out of charge note*, and thus authorises the release of the goods. If any significant discrepancy is disclosed between the duty payable on the description in the entry and the goods themselves, the importer will be required to pass a *post entry* for the additional

amount. In case of an overcharge of duty, an *over-entry certificate* is issued, which enables the importer to obtain the necessary refund.

BILL OF SIGHT

Where the importer has not received sufficient information concerning the goods to complete his form of entry, he obtains from the customs authorities a *bill of sight*, which gives him permission to examine the goods in the dock in the presence of a customs officer, and also itself constitutes a landing authority. Within three days the importer must "perfect the sight" of the goods by sending in the bill of sight endorsed with a statement showing (a) whether the goods are subject to duty; and (b) if the goods are subject to duty, whether they are for warehousing or for immediate use. Thus the bill of sight is, in effect, converted into the necessary entry, and it may cover both free and dutiable goods.

If a perfect entry is not made, the goods are removed and may be sold one month after landing, if a proper entry has not been made within that time.

SECURING RELEASE OF THE GOODS FROM THE SHIPPING COMPANY

In order to get the goods from the shipping company, one of the executed bills of lading must be presented at the company's office, if there is one at the port or, if not, to the shipbroker or firm which acts as the company's agent and arranges the berthing, unloading and clearing of its vessels, as well as the disposal of cargo and the receipt of freight charges. Before taking the bill of lading to the shipping company or its agents, however, the consignee must ensure that the shipper has endorsed the bill if it is made "to order"; and in any case the consignee himself must endorse it.

If the freight were not paid in advance by the consignor, it will now be demanded by the shipping company, and, when this and any other charges on the goods have been paid, the company or its agent will issue in favour of the importer a "*freight release*" or a "*ship's delivery order*", which is an authority addressed by the company to the master porter or superintendent in charge at the dock where the goods have been landed, instructing him to deliver the goods to the person named. The document gives particulars of the goods, specifies their marks, the number of packages, the contents and the name of the vessel.


On presenting the delivery order or freight release to the dock superintendent or to the master porter, and on payment of any

charges or dock duties which are demanded by the harbour authorities, the person collecting the goods will be given possession of them against his signature on the delivery sheet or in the delivery book kept at the dock offices.

DELIVERY AGAINST SUB-ORDERS (SPLIT CONSIGNMENTS)

If the goods are to be split up amongst a number of recipients, the importer will forward the delivery order direct to the dock

SHIP'S DELIVERY ORDER (OR RELEASE)

<p style="text-align: center;"><i>Oriental Steamship Company Ltd</i> TO THE MASTER PORTER, VICTORIA DOCK, LONDON. Please deliver to <i>Messrs M. Field & Co</i> the goods described hereunder, ex s.s. <i>Mandala</i> from <i>Singapore</i>:</p>			
Marks and Numbers		Number and Description of Packages	Contents
	1/50	50 packages	<i>Crepe Rubber</i>
<p>The shipowner will not be responsible for damage, or loss caused by fire, theft, weather or otherwise to any goods lying on the Quay or in any Quay Shed. Such goods are entirely at the risk of the owner or consignor.</p>		<p>per pro <i>Oriental Steamship Company Ltd</i> <i>James Brown</i> Agent</p>	

In some cases, the company or its agent will stamp the "release" on the back of the bill of lading thus:

<p><i>To the Superintendent, Colonial Wharf</i></p> <p>Subject to safe arrival, please release the goods detailed in the bill of lading on the back hereof.</p> <p style="text-align: right;">For <i>Oriental Steamship Co Ltd</i> (Sgd) <i>J. Black</i></p> <p>10th Jan., 19 . .</p>

superintendent, with instructions to deliver the goods against his "sub-orders". The latter will then be issued as required in favour of the various people who are to take away the goods, and must be presented to the superintendent before the respective packages can be removed.

LANDING OF BULK GOODS

Imports received in bulk, *e.g.*, sand, iron ore and coal, and not in packages, have to be weighed when they are landed from the ship, and for this purpose they may be transported in container wagons or motor vehicles which are weighed under the general supervision of the dock authorities both before and after loading. The difference between the weight before loading, *i.e.*, the *tare*, and the weight after loading, *i.e.*, the *gross weight*, gives the *net weight* of each load, and is duly recorded on a *weight note* for the benefit of the importer.

CERTIFICATE OF INDEMNITY

Occasionally, importers find that goods have arrived for them before they have received the relative bills of lading. In such circumstances they can usually get possession of the goods if they can establish a fair claim to them by showing correspondence and giving a *certificate of indemnity*, signed jointly by themselves and their bankers.

ENTRY FOR WAREHOUSING

Dutiable goods imported into this country and not wanted for immediate consumption are taken to approved *bonded store houses* and vaults established in the principal ports, where they are stored under customs surveillance until the duty thereon is paid or secured. The owners of such warehouses are required to give a *bond* to the customs authorities undertaking that the goods shall not be removed from the warehouse until the necessary duties have been paid. If the goods are to be warehoused at a place other than the port of arrival, the importer must give a bond for double the amount of the duty.

Goods taken into bond include wines and spirits, tea, coffee and tobacco; and as many thousands of pounds worth of these commodities are usually left in the warehouses, arrangements are made whereby they can be prepared by the wharfingers for sale in accordance with the owner's instructions, *i.e.*, they are sorted, tared and weighed and generally dealt with as if they were in the owner's possession.

To enable him to deposit goods in a bonded warehouse, an

importer must prepare what is known as an *entry for warehousing* as well as a *landing order*.

The entry for warehousing requires the importer's name and address and a statement of the warehouse in which the goods are to be stored. After the entry has been examined by the customs officer the *landing order* is signed by him and is sent to the place where the goods are lying. On receipt of this, the customs authorities allow the goods to be delivered to the named bonded warehouse.

Once the goods have been deposited in the bonded warehouse the importer can obtain delivery for home consumption by paying the duty and delivering to the customs officer a *warrant* certified by the warehouse keeper.

It is possible that the importer may want to deliver various portions of his goods to different persons. In that case he will deposit the warrant with the warehouse keeper and issue *delivery orders* against it. In any case he will usually pay duty only on that portion of his goods which he has already sold.

The import duty on certain foodstuffs and raw material is payable on the weight ascertained immediately after landing, but as tobacco loses weight while in process of drying in bond, it is re-weighed and the importer may elect to pay duty either on the landed weight or on the weight when delivery is taken. Wines and spirits which evaporate are also re-gauged immediately before the duty is paid. The duty on spirits is assessed on the basis of a standard strength called *proof*, and an adjustment of the rate of duty may be necessary where the spirits are over or under proof.

VALUE ADDED TAX

V.A.T. (see Chapter 16) is payable on the import of taxable goods. It is generally calculated on the net invoice price, including any carriage charged by the supplier, plus customs and/or excise duty. It is not, as in a home trade transaction, collected by the supplier, but is levied directly by the Customs and Excise Authorities.

Goods covered by the Zero Rate Schedule are also zero-rated at importation, with some few exceptions, in which case the goods will be taxable at the appropriate rate on importation. There is no relief from tax on the importation of any goods merely by virtue of their being mentioned in the V.A.T. Exemption Schedule. Goods covered by the Exemption Schedule are taxable at the appropriate rate on importation.

It should be noted that transactions with the Channel Islands and with the Continental Shelf outside U.K. territorial waters are treated as imports and exports; but not transactions between Great Britain

and Northern Ireland, nor between Great Britain and the Isle of Man.

RE-EXPORTING

Those goods which, for the convenience of the importer, have been stored in a bonded warehouse pending payment of the customs or excise duties, can be exported without payment of the duty provided the following formalities are complied with:

A *bond*, undertaking that the goods will be properly exported or otherwise accounted for to the customs authorities and signed by the exporter (or his agent) and a surety, must be executed in the presence of a customs officer. In case of default the signatories are liable to a penalty of twice the amount of the duty involved. A *general bond* is a similar instrument, except that instead of covering one particular transaction, it is operative for any number of shipments covered by the penalty stated in the bond.

A signed *bond note* is then obtained from the customs bond clerk in exchange for the bond. On the reverse side of the bond note are recorded particulars of the goods to be exported and a *warehouse-keeper's order*, requiring the warehouse-keeper to deliver the goods, which is signed by an officer of the warehousing department of the custom house. A *shipping bill* is now prepared and forwarded to the customs officer on board the exporting vessel, informing him of the goods which are being shipped.

All these documents are then handed to a licensed carman or lighterman, who gives them up in exchange for the goods. The subsequent procedure is as already described.

TRANSHIPMENT

In some cases goods may have been purchased from abroad for re-export and it may be possible to tranship the goods from one vessel to another without the necessity of first warehousing them. This procedure can be carried out only at certain ports, *e.g.*, Bristol, Grimsby, Hull, Liverpool and Southampton. All such goods must be specifically indicated as "in transit" in the ship's report. A similar procedure may also be followed at certain airports.

If the goods are not subject to duty, the importer must fill in an "entry for free goods in transit on through bill of lading", together with a "specification for foreign and colonial goods free of duty in transit on through bill of lading"; the first of these documents serves as a warrant to authorise unloading, and the latter is necessary to comply with the export formalities.

CUSTOMS AND EXCISE DRAWBACK

Customs and excise duties are levied only on goods for home consumption. Consequently, when goods on which excise duty has been paid are exported, or when goods which have been subjected to customs duty are re-exported, the exporters and re-exporters respectively would be handicapped were it not that they are entitled to a refund or return of the duty paid by them. This allowance is known as *excise drawback* in the first case, and as a *customs drawback* in the other.

When goods entitled to drawback have been entered and shipped for export, a certificate known as a *customs debenture* is issued by the customs authorities, on which the exporter declares that the goods have actually been exported and are not intended to be re-landed in the United Kingdom.

PROHIBITED AND RESTRICTED IMPORTS

In general, there are few restrictions imposed by the Government on the import of goods. Under the *Import, Export and Customs Powers (Defence) Act* 1939, the Department of Trade is empowered to regulate or, in some cases, prohibit, the import or export of goods. Some other Departments have special powers to control imports for specific purposes. Prohibited goods are usually those of an injurious nature or of a type the import of which would involve some contravention of the law, *e.g.*, infected cattle. Explosives, for example, and radioactive materials, require a specific *import licence*. Some goods may be subject to *quota restrictions*. A *general import restriction* may be imposed, for example, on goods from a specified country, as in the case of sanctions against the illegal regime in Rhodesia.

RE-IMPORTATION OF GOODS EXPORTED

Where *British* goods are exported and within five years are re-imported they are entered by "*bill of store*". The importer must furnish satisfactory proof of the original shipment and, if the goods can be identified, they will be released free of duty on repayment to the customs of any drawback or other allowances which were granted when the goods were exported.

PROCEDURE ON RELEASE OF GOODS

Having now briefly reviewed the various customs formalities which have to be attended to by the importer, a typical example of the

import of goods on consignment may be considered, such as that referred to in the specimen *pro forma* invoice on page 407, relating to an import of rubber.

The required entry having been made at the custom house and the approved copy having been presented at the dock, it is probable that the rubber would be placed in a warehouse and that the importers would give instructions to a firm of brokers to sell the consignment on the London Commodity Exchange.

The expenses of warehousing would be paid by the importer, who would receive from the selling broker a contract note showing the prices at which the rubber had been sold, together with his expenses and brokerage. The amounts due from the buyers will be paid directly to the importer at the due date, or *prompt*, as it is called, whilst the brokerage and sale expenses will be paid by the importer to the broker immediately. On his disbursements the consignee (the importer) will charge interest against the consignor, together with commission on the gross sales amount.

All these details are included in an *account sales* which is prepared by the importer and forwarded to the exporter. Payment of any balance outstanding may be made either by the consignee sending a remittance, or by the exporter drawing a bill of exchange upon the importer for the net amount of the account sales.

IMPORTS AND E.E.C. OBJECTIVES

Article 2 of the *Treaty of Rome* 1957, which set up the European Economic Community (E.E.C.), known also as the Common Market, states that the Community's main task is "by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities. . . ." Article 3, which enumerates the Community's main activities, includes the elimination, as between Member States, of customs duties and of quantitative restrictions on the import and export of goods and of all other measures having equivalent effect. In accordance with its obligations as a member of the European Community (and I.M.F. and G.A.T.T.) Britain has removed quantitative restrictions almost entirely from its import of goods from a large number of countries. As the "harmonious development of the economic policies" within E.E.C. progresses, it is likely that considerable changes in Britain's import policies and procedures will take place.

Part VI

Money, Banking and Finance

CHAPTER THIRTY-TWO

Money and Methods of Remittance

In the early stages of society's development, the exchange of goods was effected by *barter*, that is, by the direct exchange of goods for goods. The hunter with more meat than he needed would exchange his surplus for the surplus fish of the fisherman or the surplus wool of the herdsman. This system depended upon the double coincidence of wants and possessions, a matter of difficulty in a small community and impossible in a large and growing one. There was also the problem of comparing the values of the commodities offered in exchange.

To facilitate exchange as communities grew, barter was superseded by a system of sale and purchase, the indirect exchange of goods. In this system an intermediary commodity was used to effect the exchange. Money is this intermediary commodity.

DEFINITION OF MONEY

Money may be defined as *a commodity chosen by common consent to be a measure of value and a means of exchange between all other commodities*. The commodity used as money must be generally acceptable within the community in exchange for goods and services and in final settlement of obligations. Although money may exist in numerous forms, its universal purpose is that it shall be used, either now or in the future, to command in exchange for itself the labour or the product of the labour of others. Money, therefore, is a means to an end, the end being the ability to obtain the goods and services of others.

Money has taken a variety of forms. Beads, shells and cattle have been used in undeveloped communities and developed communities have used gold and silver as money, both coins and bullion. Now paper money largely replaces coins. Bank notes are used to settle a vast amount of the transactions carried out in industrial communities and bank deposits subject to withdrawal by cheque are responsible for the bulk of transactions in such communities. Many other things act as media of exchange, including bills of exchange; they are *near-money*. "Money is as money does", and all media of exchange are effective money as long as they facilitate exchange and actually do the work of money.

The term *currency* denotes those forms of money which are issued by the State or whose circulation is enforced by the State. A pound note, for example, is currency, but a bill is not.

LEGAL TENDER is that money which can be offered in final discharge of a debt and cannot legally be refused by the creditor. It is because bank notes are legal tender that they have value as money although they have little material value.

UNLIMITED LEGAL TENDER is money that can be tendered up to any amount and LIMITED LEGAL TENDER is money that can be offered in discharge of debts up to a certain amount only.

THE FUNCTIONS OF MONEY

Briefly, money must be capable of serving as:

- (1) A MEDIUM OF EXCHANGE, universally accepted in exchange for other commodities.
- (2) A MEASURE OF VALUE, by which the values of other commodities can be compared in terms of their money prices.
- (3) A STORE OF VALUE, so that funds may be set aside for future use without fear of loss or deterioration.
- (4) A STANDARD OF DEFERRED PAYMENTS, by means of which payment of an equivalent value can be obtained at a future date for a loan or exchange made now.

THE CHARACTERISTICS OF MONEY

Money, whatever its form, must possess one essential characteristic; it must be *generally acceptable* in a community, *i.e.*, it must be such that anyone will take it without hesitation in exchange for goods and services. The precious metals had obvious advantages in this respect as they could be used in the arts and elsewhere, but bank notes, which have little value in themselves, are acceptable only because the Government declares that they are legal tender and they must, therefore, be accepted in payment for goods and services.

Even legal tender may not be acceptable at times, as in a period when money is rapidly losing its value and people become reluctant to exchange their goods and services for money, preferring to receive in exchange other goods that are likely to retain their value. Cigarettes, coffee and other commodities of which there was a shortage were used as media of exchange in occupied and liberated countries during and after the Second World War, and works of art, jewellery and property are preferred to money by some people as a store of value in the inflationary conditions that persist in the countries of the western world.

Money should be stable in value; it should not be subject to violent fluctuations in demand or supply that would cause frequent changes

in its value. Over a long period, the value of gold was stable but owing to the very great shortage and constantly increasing demand for the metal, gold no longer functions as a satisfactory medium of exchange and bank notes have taken its place.

BANK NOTES

Bank notes function excellently as a medium of exchange. They are portable and convenient and, though not very durable, can be replaced at very little cost. Intricate designs and elaborate watermarks give the notes ready cognisability and render forgery extremely difficult.

Bank notes are usually issued for the State by the central banking institution, as the Bank of England in the United Kingdom, and are subject to legal control. They may be *convertible* or *inconvertible*.

Convertible notes are legally exchangeable on demand for a fixed quantity of the standard metal, *i.e.*, gold or silver. Bank of England notes, before 1914, were strictly convertible, *i.e.*, legally exchangeable for gold coin, and recognised everywhere as being as good as gold. They enjoyed world-wide acceptability. Today they are inconvertible.

Inconvertible notes give the holders no legal right to demand conversion into metal. Their issue is legally controlled and if the issue is not carefully regulated according to current trade requirements, their value will depreciate and they may become worthless. A rigidly controlled inconvertible paper currency may, however, serve as good money and entail relatively little expense of upkeep.

COINAGE

The earliest form of metallic money consisted of lumps of bullion, which were measured by weight, and had to be tested for fineness, *i.e.*, the proportion of the pure metal to alloy. The fineness and weight of metallic money are now certified by impressing a recognised design on the metal and any alteration in the standard weight or fineness can be easily detected. A piece of metal so impressed is known as a *coin*, which may be defined as a piece of metal used as a medium of exchange, stamped by the issuing authority and generally accepted without immediate reference to its weight or fineness.

TOKEN COINS are worth more as coins than as bullion. They are used only for transactions of small amount and retain their exchange value because they are legal tender up to a certain amount and because their issue is limited. British coins of cupro-nickel and bronze are token coins.

THE VALUE OF MONEY

Since money is a commodity, it is obvious that its value will be subject to variations in the same way as the value of any other commodity. But in estimating the extent of variations in the value of money a difficulty arises by reason of the fact that, whereas the value of other commodities is usually expressed in terms of one commodity—money—there is no *one* commodity in terms of which the value of money itself may be measured. The value of money can, however, be measured by ascertaining the quantities of other commodities for which it will exchange; thus the value of money rises if more commodities can be purchased with a given unit of money, and falls if a smaller quantity only of the same commodities can be bought. Briefly, *the value of money varies inversely to the general level of prices.*

PRICE INDEX NUMBERS

Changes in this general level are difficult to measure, because prices do not all fluctuate in the same degree or in the same direction. Over a given period, the prices of certain commodities may rise, while those of other commodities may fall. For this reason the approximate changes in prices over a series of years are measured by means of *price index numbers*. In compiling price index numbers it is usual to compare the prices of a number of commodities and to give due regard to the relative importance of each in the scheme of expenditure by *weighting* (i.e., multiplying each price by a factor estimated to represent its comparative degree of importance).

There are several kinds of index numbers used to measure changes in the prices of groups of commodities; there are general commodity index numbers, based on wholesale prices, and there is an index of retail prices.

The *Index of Wholesale Prices* is based on almost 11,000 products, including imports, and is published monthly by the Department of Trade.

The *General Retail Prices Index*, formerly known as the *Cost of Living Index*, is published monthly in the *Department of Employment Gazette*. The Retail Prices Index Advisory Committee, formerly known as the Cost of Living Advisory Committee, is appointed by the Secretary of State for Employment and advises him on the compilation of the Index. The Committee includes representatives of the C.B.I., T.U.C., economists and statisticians.

- (a) The items which are considered as making up an "average basket" bought by U.K. households are divided into 11 broad groups: food; alcoholic drinks; tobacco; housing; fuel and

- light; durable household goods; clothing and footwear; transport and vehicles; miscellaneous goods; services; meals bought and consumed outside the home.
- (b) Items within the groups are chosen so as to represent price movements of commodities and services *as a whole*.
 - (c) For all items together, around 150,000 prices are collected each month from selected areas grouped on a population basis, thus: Greater London—25 areas; towns with a population of 200,000 and over—26 areas; towns of 50,000 to 200,000—54 areas; towns of 10,000 to 50,000—48 areas; towns of under 10,000—47 areas. In each selected area the price of an item is collected from up to five shops. Different types of locality are represented within the population groups and allowance is made for lower purchasing power in the smaller towns.
 - (d) The prices or charges used are for cash transactions only.
 - (e) Prices of items supplied by retailers on returns sent direct to the Department of Employment, *e.g.*, for clothing, are calculated on the basis of price relatives in four groups covering multiple undertakings, department stores, co-operative societies and other retailers. The relatives for the four groups are combined to give section indices.
 - (f) Section indices for *all* items are computed and weighted by the *Family Expenditure Survey* series of weights, calculated in relation to the comparative importance of items in the family budget. An all-items index is then produced relating changes in prices to those of a base year.
 - (g) The index is calculated on the basis of prices on one selected Tuesday in each month, usually between the 16th–22nd of that month.

THE EFFECTS OF RISING PRICES

Fluctuations in the value of money often have far-reaching effects. Although the advantages are temporary and, therefore, superficial, rising prices are often regarded as beneficial to production. They tend to widen profit margins and *thus to benefit the business man*. This is because production is initiated in anticipation of demand and the producer secures a higher price for his goods than he expected; moreover, the bulk of his standing costs, such as rent and wages, are relatively fixed and respond slowly to the upward movement of prices. The effect of this is that business confidence is stimulated and a rapid increase in productive activity takes place. Rising prices are sometimes said, therefore, to be “good for trade”.

But while rising prices benefit the producers and those who have

fixed payments to make (*e.g.*, companies paying debenture interest), they bring hardship to those in receipt of fixed incomes in the form of salaries and interest from Government stocks. Wage-earners tend to suffer, except in as far as employment and overtime can be increased, as the adjustment of wages lags behind the changing price level.

Another effect is that debtors gain and creditors lose, as money borrowed when it was dear is paid back when it is cheap. Governments, as the biggest debtors, gain very substantially.

THE EFFECTS OF FALLING PRICES

Falling prices have a reverse effect from that of rising prices and, in view of their retarding influence on production, can be harmful.

A fall in prices means reduced profit-margins. Producers endeavour to curtail production or at least to refrain from expanding. Standing charges and costs of raw material tend to exceed receipts. This increases the general depression, and explains why it is often said that falling prices are "bad for trade".

Wage-earners, to some extent, tend to gain, for the fall in wages lags behind the fall in prices, but wage-earners bear their share of the burden in the heavy unemployment that a period of falling prices usually involves. Those receiving fixed incomes benefit, *e.g.*, annuitants, pensioners and holders of fixed-income bearing securities. Creditors gain and debtors lose. The Government, in its capacity of debtor, loses heavily.

INFLATION, DEFLATION, DISINFLATION AND REFLATION

INFLATION has been described as an expansion of the supply of purchasing power beyond the amount required to supply the needs of the community at the existing price level. Where the volume of purchasing power runs ahead of production in a continuing fashion, the phenomenon is referred to as "persistent inflation". A severe and continuing inflation is referred to as "hyperinflation". Where prices are pushed upwards as a result of rising costs of production, the process is known as "cost-push inflation"; where inflation stems from an excess of aggregate demand over aggregate supply at the current level of prices, it is known as "demand-pull inflation". Attempts have been made to hold inflation in check by restricting purchasing power, *e.g.*, by prices and incomes control, by increases in taxation, by savings campaigns, restriction of imports. Inflation in the 1970s has proved, for most governments, an intractable problem and has emerged as a severe threat to financial and social stability.

DEFLATION denotes a corresponding contraction of the supply of currency and of spending.

Unless deflation is effectively controlled, it can have consequences as harmful as those associated with inflation. When prices are falling rapidly capital development decreases, and repair and renewals are reduced to a minimum. Trade generally becomes depressed and unemployment increases.

DISINFLATION is a deliberate contraction of purchasing power designed to check inflation and to avoid the depressing effects of deflation. It is achieved by means of fiscal policy (a budget surplus is induced by increasing existing taxes and introducing new ones) and monetary policy (interest rate rises and other measures to restrict credit).

REFLATION. Deflation can bring problems to a community, especially as it is likely to curb industrial activity and increase unemployment. Then steps may be taken to stimulate the economy and check the fall in prices. Currency and credit are deliberately expanded and tax reductions made which bring about increased demands for goods and so lead to a fuller use of the factors of production.

THE BRITISH MONETARY SYSTEM

The currency of the United Kingdom consists of bank notes and token coins of cupro-nickel and bronze. Though the gold sovereign is still nominally the standard coin and is still legal tender, gold coins have been withdrawn from circulation and are no longer minted for home circulation. The legal tender system is as follows:

UNLIMITED LEGAL TENDER

Bank of England notes of £20, £10, £5 and £1 are legal tender for the payment of any amount in England and Wales, Scotland and Northern Ireland.

LIMITED LEGAL TENDER

Bronze coins—½p, 1p and 2p—are legal tender for payments up to 20p.

Cupro-nickel 50p coins are legal tender up to £10 and 5p and 10p coins, in any combination, up to £5.

SCOTTISH AND NORTHERN IRISH BANK NOTES are *not* legal tender in their respective countries, though Northern Irish bank notes are good tender for the payment of revenue duties.

DECIMAL CURRENCY

Most currencies of the world are now based on the decimal system which is almost universally understood. In view of the importance of Britain's export trade the decimal system was introduced on 15th February, 1971.

The £ is the standard unit; it is divided into 100 units known as new pence (abbreviation p). There are six coins—50p, 10p, 5p, 2p, 1p and $\frac{1}{2}$ p.

There was no change in the note issue except that the 10s note was replaced by a 50p coin.

METHODS OF REMITTING MONEY

Various facilities for sending money to creditors are available for those who have payments to make over distances. The Post Office and the banks provide means by which payments can be effected without the actual transmission of currency.

POSTAL REMITTANCES

POSTAL ORDERS

Postal orders are a convenient and safe means of remitting moderate amounts to a named payee. Such orders—obtainable from any post office on payment of a fee known as "poundage" which varies with the value of the order—are available in certain values from 10p to £10 and are valid for six months from the last day of the month of issue.

The sender of a postal order may guard against the risk of its falling into wrong hands by filling in the name of the payee and the name of the post office at which the order is to be payable. Postal orders may also be crossed in the same way as a cheque, in which case payment will be made only through a bank.

If these precautions are taken, postal orders are a fairly safe form of remittance, since they are "not negotiable". Sometimes only the name of the payee is inserted, and the town or office of payment is left blank, so that the payee can suit his convenience as to the place of payment. In such a case, a payee who demands payment in person must insert the name of the post office as well as sign a receipt for the money in the space provided; but this is not necessary if payment is obtained through a bank, for the latter will cross the order with its own stamp.

Every postal order has a detachable counterfoil which should be filled in with the name of the payee and with the date of despatch, and be detached and retained by the payer. The counterfoil shows

the serial letters, number and amount, of the postal order, and should be produced in the event of any inquiry or claim concerning a lost or stolen order.

MONEY ORDERS

Ordinary money orders are no longer issued by British post offices, but *telegraph money orders*, payable in the United Kingdom and certain foreign countries, can be obtained on application at most post offices. The cost of the telegram in addition to poundage must be paid. Abbreviated addresses may be included in these orders. Details of current charges and limits are given in the *Post Office Guide*.

Foreign money orders are issued, subject to exchange control regulations, payable in foreign currency and may be transmitted by mail or by telegraph.

CASH ON DELIVERY (C.O.D.)

The post office, on payment of a collecting fee, will accept and deliver a postal packet, sent by First Class Service, accompanied by an order requiring the addressee to pay a sum specified in the order for transmission back to the sender. This sum, known as the Trade Charge, must be paid at the time the packet is delivered to the addressee. An official gummed label must be used, bearing spaces for the names and addresses of the sender and the addressee with the amount of the trade charge. Service is restricted to letters, parcels and packets not exceeding £100 in value.

Mail-order firms use this service to a considerable extent.

BANKING REMITTANCES

Post office methods of remitting money are of slight importance in comparison with the various methods of payment available through the medium of a bank. A large proportion of internal trade debts are settled by the remittance of *cheques* and *credit transfers*, while debts arising out of international trade may be discharged by creditors drawing *bills of exchange* on the debtors.

CHEQUES

Cheques are discussed in some detail in Chapter 34; here it is noted that if a cheque is payable to a specified payee or his order, a bank will not accept it for collection for other than the named payee unless the payee has endorsed it. A cheque may be *crossed generally* or *specifically*

and if so crossed it is a comparatively safe and economical method of transmitting money.

CREDIT TRANSFER SYSTEM

British clearing banks operate a *giro* credit system whereby a debtor pays his debt through the banking system direct into his creditor's bank account, instead of by sending a cheque which the creditor would pay into his bank for collection. The system has two forms. In one, the *traders' credit slip system*, a trader periodically gives his bank a list in duplicate of his creditors, showing the names, branches and sorting codes of their banks and the amount he wishes to pay to each. He provides also *credit slips*, one for each payment, giving the same information, his own name and a cheque for the total of the slips. The slips are passed by the payer's bank through the bankers' credit clearing to the creditor's bank, which credits the amount to the payee's account and sends him advice of the payment. By using this system the customer is saved the trouble involved in drawing separate cheques for each amount, while he is freed from all risks that the money may not reach the correct quarter.

In the other form of credit transfer, a private person with debts to pay can fill in a *credit transfer form* (provided on bank counters) for each payment. He hands these over the counter with a cheque for the total if he is a customer of the bank, or cash for the total plus a small charge for each payment if he is not. The slips are passed through the banking system to the credit of the payees' accounts. Many public undertakings (*e.g.*, gas and electricity boards and water companies) and firms selling goods on hire purchase provide tear-off credit slips on their accounts to facilitate this method of payment.

BILLS OF EXCHANGE

Bills of exchange, used in the settlement of international indebtedness, are dealt with in Chapter 33.

Briefly, a bill of exchange is a document by which a creditor instructs his debtor to pay a named amount on demand or on a specified date, to a named person or his order, or to bearer. The debtor may signify his undertaking to comply with the order embodied in the bill by signing his name across the face, in which case he is said to *accept* the bill. In this way, the creditor obtains a document embodying a legally enforceable promise on the part of the debtor (*i.e.*, the acceptor) to pay the debt owing on demand or on the stipulated date.

The creditor can obtain payment of his debt in three ways: (a) he

can hand the bill to his banker for *collection* from the drawee or acceptor at maturity, or (b) he can sell the bill to his banker for its face value, less interest for the period it has to run (this procedure is known as *discounting* or *negotiating* the bill with a banker); or (c) he can transfer or negotiate the bill to another person for value, and leave it to that person to collect payment of the bill from the drawee or acceptor.

Bills drawn payable "on demand" or "at sight" are payable immediately upon presentation to the drawee.

Bills of exchange are seldom used now except in foreign trade. Inland trade is usually conducted on the "open account" basis whereby the debtor remits to his creditor the amount due from time to time. In this system, the creditor is unable to obtain as rapid a return of his funds and he may therefore have to obtain finance for his business by means of an overdraft from his banker. This method tends to be cheaper in the long run, although overdraft rates are higher than the discount rate, because interest is paid only on the actual amount of the overdraft required; that is to say, the bank advance is more flexible.

BANKERS' DRAFTS

Instead of the creditor himself drawing a bill on the debtor, it is possible for the debtor to purchase a draft from his banker and to send this draft to the creditor in settlement of the debt owing. Such a draft which is as good as cash takes the form of a bill drawn by the issuing bank upon a branch or correspondent in the creditor's town, from whom the creditor can collect payment of the amount either on demand or on the expiration of the period specified in the draft, as the case may be. As a general rule the draft will be payable on demand. If the draft is drawn by one branch on another of the same bank, it is not legally a bill of exchange.

MAIL AND TELEGRAPHIC TRANSFERS

Owing to the risk of loss or theft that is involved in the remittance of bankers' drafts from one country to another, the method of remittance by *Mail Transfer* (M.T.) is widely used. A mail transfer may be defined as an order to pay contained in a letter sent by a banker to his agent in a foreign centre. *Air-Mail Transfers* (A.M.T.) are the same but they are advised by airmail. The M.T. is advised in duplicate by successive mails.

A *Telegraphic Transfer* (T.T.) resembles a mail transfer in many ways, but as the advice is telegraphed or cabled by the banker to his

agent abroad, payment thereunder can be effected within a few hours of despatch from the issuing centre. Owing to the speed with which the transfer is made and the cost of the telegram or cable, telegraphic transfers are a more expensive form of remittance than mail transfers or banker's drafts.

M.T.s, A.M.T.s and T.T.s are invariably expressed in the currency of the country of destination but the remitter is at liberty to specify payment of:

- (a) an amount in foreign currency, say, \$1,000 or
- (b) the equivalent of an amount of sterling, say, £500.

Payment may be required to be made in full or after deduction of the expenses of the transfer. Compliance with any exchange control regulations is, of course, necessary.

THE GIRO SYSTEM

The Post Office operates the *National Giro*, located at Bootle, Merseyside, an institution for making monetary transfers such as the paying of bills—gas, electricity, insurance, rates, telephone, etc.—as an alternative to bankers' cheques, the postal order, money order or registered packet. An initial deposit of not less than £1 must be made to open an account and a credit balance must always be kept at a post office. Payments for any amount can be made in cash at any post office to the credit of an account-holder, or by an account-holder despatching a postal transfer from his own Giro account. No charge is made for transfers between accounts. A free updated balance is sent after an account is credited or after every ten transactions.

Postal cheques can be purchased, which are payment orders instructing the National Giro Centre to pay other people. They can be cashed at a named post office or paid into a bank account. A Giro directory containing the account numbers of all holders is available for consultation at the post office.

Account holders have their own cheque books which can be used to draw up to £50 in cash from any two post offices.

Cheque guarantee cards (enabling the holder to draw cash up to £50 from any post office in the U.K.), personal loans and bridging loans, for the purpose of home purchase, are also available.

CHAPTER THIRTY-THREE

Bills of Exchange and Promissory Notes

(References here are to sections of the *Bills of Exchange Act 1882*.)

This chapter examines some of the legal characteristics of the bill of exchange and of the promissory note—a similar type of instrument. A bill of exchange is defined as:

“An unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money or to the order of a specified person, or to bearer”: s. 3 (1).

From this definition we deduce eight requisites as to the form of a valid bill:

- (1) THE BILL MUST BE AN ORDER and not a mere request. The mere addition of words of courtesy, *e.g.*, “Please Pay *X*”, will not, however, invalidate the bill.
- (2) THE ORDER MUST BE UNCONDITIONAL, *i.e.*, payment must not be conditional upon the performance of any act or circumstance.
- (3) THE ORDER MUST BE IN WRITING. This includes typewriting or print.
- (4) THE ORDER MUST BE ADDRESSED BY ONE PERSON TO ANOTHER. A bill in which drawer and drawee are the same person is not a valid bill.
- (5) THE ORDER MUST BE SIGNED BY THE PERSON GIVING IT, *i.e.*, the drawer. The person signing may do so if authorised on behalf of a principal, *e.g.*, a director signing *per pro* a company.
- (6) THE BILL MUST BE PAYABLE ON DEMAND OR AT A FIXED OR DETERMINABLE FUTURE TIME. If the date of payment depends on the happening of any event which is certain to happen, the bill is perfectly valid, but a bill payable on a contingency is invalid.

£1000

London, 1st March 19..

Three months after date pay to *John Wood* or order the sum of *One thousand pounds*

To *James Arthur, Esq.*,
Manchester

Thomas Jones

Inland Bill payable after Date

Thus a bill payable "three months after the death of *X*" is a good bill, for *X* is certain to die one day; but a document drawn "Pay *X* on the marriage of *C*" is not a bill, for it is quite possible that *C* may never marry.

\$5000.00

Chicago, 1st March 19..

Sixty days after sight of this first of exchange (second and third of even tenor and date unpaid) pay to *Third City Bank, Chicago*, or order, the sum of *Five thousand dollars*, and place to account of shipment of machinery per s.s. *Kildare* as advised.

To *General Importers Ltd,*
Liverpool

Arthur Riley

Foreign Bill drawn in a Set

- (7) THE ORDER MUST REQUIRE PAYMENT OF A SUM CERTAIN IN MONEY. Such a sum may, however, be expressed to be payable with interest, or by stated instalments (with or without a provision that upon default in payment of any instalment the whole shall become due), or according to an indicated rate of exchange to be ascertained as directed by the bill: s. 9 (1).
- (8) THE BILL MUST BE PAYABLE TO OR TO THE ORDER OF A SPECIFIED PERSON, OR TO BEARER. Where the bill is drawn payable to a stated person it is deemed to be payable to him "or to his order"; that is to say, he may endorse it in favour of another person. There is no objection to the payee being the same person as either the drawer or the drawee.

DATE OF BILL

The date of a bill is usually written by the drawer in the top right-hand corner. An undated bill is quite valid, however, and will be considered as bearing the date on which it was issued. Further, a bill is not invalid merely because it is ante-dated or post-dated or because the date shown is a Saturday, Sunday or Bank Holiday.

INLAND AND FOREIGN BILLS

"An inland bill is a bill which is or on the face of it purports to be (a) both drawn and payable within the British Islands or (b) drawn within the British Islands upon some person resident therein. Any other bill is a foreign bill": s. 4 (1). The term "British Islands" in this Section includes any part of the United Kingdom, the Isle of Man and the Channel Isles; it does not include Eire.

THE DUE DATE OF A BILL

If a bill is not payable on demand it is due and payable in all cases on the last day of the time of payment as fixed by the bill or if that is a non-business day on the succeeding day: s. 14 (1). The term "month" in a bill means a calendar month period of 31 days.

WHAT IS A NEGOTIABLE INSTRUMENT?

An instrument is negotiable when it is, by legally recognised custom of trade or by law, transferable by delivery or by endorsement and delivery, without notice to the party liable, in such a way that the holder of it for the time being may sue upon it in his own name, and that the property in it passes to a *bona fide* transferee for value free from equities and free from any defect in the title of the person from whom he obtained it.

Although the Courts will recognise any instrument as negotiable if it be shown to be so recognised by an established custom of trade, the following can for present purposes be regarded as a comprehensive list of negotiable instruments: bills of exchange, promissory notes, cheques, bearer bonds, scrip certificates and share warrants to bearer and debentures to bearer. Amongst the more common commercial instruments which are transferable but *not* negotiable are share certificates, bills of lading and postal orders.

THE PARTIES TO A BILL

From an examination of the specimen bill appearing on page 431, it will be observed that the names of three persons appear on the face of each bill, e.g., in Specimen No 1, the *drawer* (Thomas Jones), the *drawee* (James Arthur), and the *payee* (John Wood). Of these persons, however, only one, the drawer, has become a party to the bill by signing it as evidence of his liability thereon. A bill may, in fact, be perfectly valid if it bears the signature of the drawer as the only party but there are, in general, at least three parties to a bill. These are:

- (1) THE DRAWER, the person addressing the order.
- (2) THE ACCEPTOR, the name given to the *drawee* (the person to whom the order is addressed) as soon as he has signified his undertaking to comply with the order contained in the bill by accepting it by his signature written across the face of the bill.
- (3) THE ENDORSER, the name given to any other person signing a bill, usually on the back. A bill payable "to order" is not capable of negotiation until it has been endorsed by the *payee*.

It should be noted that the *payee* is not, as such, a party to the bill.

Thus a bill payable "three months after the death of *X*" is a good bill, for *X* is certain to die one day; but a document drawn "Pay *X* on the marriage of *C*" is not a bill, for it is quite possible that *C* may never marry.

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- (3) THE ENDORSER, the name given to any other person signing a bill, usually on the back. A bill payable "to order" is not capable of negotiation until it has been endorsed by the *payee*.

It should be noted that the *payee* is not, as such, a party to the bill,

since he incurs no liability thereon. He has, however, certain rights on the bill (which are treated below), and, in any case, becomes liable as an endorser as soon as he endorses the instrument.

THE SIGNATURE TO A BILL

Capacity to incur liability as a party to a bill is co-extensive with capacity to contract (s. 22 (1)), *i.e.*, anyone who has capacity to bind himself by contract may bind himself by signing a bill. However a minor (*i.e.*, a person under the age of 18 years) is never liable on a bill even if he might be liable on the transaction giving rise to it. By s. 23, no person is liable as drawer, endorser, or acceptor of a bill who has not signed it as such; but:

- (1) Where a person signs a bill in a trade or assumed name, he is liable thereon as if he had signed it in his own name;
- (2) The signature of the name of a firm is equivalent to the signature, by the person so signing, of the name of all persons liable as partners in that firm.

DELIVERY

Every contract on a bill, whether it be the drawer's, the acceptor's or an endorser's, is incomplete and revocable until effect has been given to it by delivery of the instrument. But where an acceptance is written on a bill, and the drawee gives notice to the person entitled to the bill that he has accepted it, the acceptance then becomes complete and irrevocable: s. 21 (1). In all cases, however, the delivery, to be effective, must be made either by or under the authority of the person responsible for it, *i.e.*, by the drawer, acceptor or the endorser. Moreover, the delivery may be shown to have been conditional, or for a special purpose only, and not for the purpose of transferring the property of the bill. Nevertheless, where a bill is no longer in the possession of a party who has signed it as drawer, or acceptor, or endorser, a valid and unconditional delivery by him is presumed until the contrary is proved: s. 21 (3).

“HOLDER” AND “BEARER”

The *holder* of a bill is the payee or endorsee who is in possession of it, or the bearer thereof. The *bearer* is the person in possession of a bill payable to bearer and a bill is payable to bearer which is expressed to be so payable, or on which the only or last endorsement is an endorsement in blank.

A *holder in due course* is a holder who has taken a bill, complete and

for lack of funds, unless he knew that it would not be paid, but he is always liable if there is a prior forgery.

NEGOTIATION OF BILLS

A bill is negotiated when it is transferred from one person to another in such a manner as to constitute the transference the holder of the bill. A bill payable to "bearer" is negotiated by delivery, whilst a bill payable to "order" is negotiated by the endorsement of the holder completed by delivery: *s.* 31.

ENDORSEMENTS

There is no statutory definition of the word "endorsement", but the term is here used to denote the signature of a person, usually the payee or endorsee, on the back of a bill of exchange. To be effective as an endorsement and to operate as a negotiation of the bill, it must be written on the bill itself or on an allonge (*i.e.*, a slip of paper annexed to it), and be an endorsement of the entire bill, as a partial endorsement will not operate to negotiate the bill, and where the bill is payable to the order of two or more persons (not being partners) all must sign unless the one signing has authority to sign for the others.

Classes of endorsement include:

- (1) **ENDORSEMENTS IN BLANK.** An endorsement in blank consists of the simple signature of the endorser on the back of the bill. Such an endorsement by the payee or endorsee of an order bill renders the bill payable to "bearer".
- (2) **SPECIAL ENDORSEMENTS.** A special endorsement is one which specifies the name of the person to whom or to whose order the bill is to be made payable, *e.g.*, on a bill payable to John Jones or order, "Pay to the order of William Smith—John Jones."
- (3) **CONDITIONAL ENDORSEMENTS.** A conditional endorsement is one which makes the transfer of the property in a bill subject to the fulfilment of a stipulated condition, *e.g.*, "Pay Arthur Evans on delivery of bills of lading."
- (4) **PARTIAL ENDORSEMENTS.** An example of a partial endorsement would be "Pay John Jones eighty pounds" on a bill for £100. An endorsement in this form operates as an authority to receive the sum specified, but is ineffective as a negotiation of the bill.
- (5) **RESTRICTIVE ENDORSEMENTS, *e.g.*,** "Pay William Smith *only*—John Brown," or "Pay Midland Bank, Ltd, for the credit of my account—John Brown." A restrictive endorsement gives the endorser the right to receive payment of the bill and to sue on the bill but he cannot transfer the bill unless it expressly permits him to do so.

- (6) ENDORSEMENTS NEGATIVATING OR LIMITING THE ENDORSER'S LIABILITY. Where the endorser adds to his signature words such as *sans recours* or *without recourse to me*, he incurs no liability other than that of a transferor by delivery. The addition of words such as *sans frais*, without expense", or "no charges", will exempt him from liability for any notarial or other charges.

OVERDUE BILLS

A bill which remains in circulation after the due date is said to be *overdue*. Such a bill can only be negotiated subject to any defect of title affecting it at its maturity, and thenceforward no person who takes it can acquire or give a better title than that of the person from whom he took it: s. 36 (2). Similarly, a bill payable on demand is deemed to be overdue for purposes of negotiation when it appears on the face of it to have been in circulation for an unreasonable length of time.

In order to render the drawer liable, presentment of a bill on demand must be made within a reasonable time after its issue, and within a reasonable time after its endorsement, in order to render the endorser liable: s. 45 (2).

MATERIAL ALTERATION

Where a bill is materially altered without the assent of all parties liable thereon, the bill may be avoided except as against any party who has himself made, authorised or assented to the alteration, and against subsequent endorsers. But when a bill has been materially altered, and the alteration is not apparent, a holder in due course may avail himself of the bill as if it had not been altered, and may enforce payment of it according to its original tenor: s. 64 (1).

In particular the following alterations are material: namely, any alteration of the date, the sum payable, the time of payment, the place of payment, and, where a bill has been accepted generally, the addition of a place of payment without the acceptor's consent: s. 64 (2).

ACCEPTANCE, PAYMENT AND DISHONOUR

GENERAL AND QUALIFIED ACCEPTANCES

An acceptance may be either *general* or *qualified*: s. 19. A *general acceptance* is one that assents without qualification to the order of the drawer, while a *qualified acceptance* in express terms varies the effect of the bill as drawn.

There are five types of qualified acceptance:

- (1) **CONDITIONAL**, *e.g.*, "Accepted subject to the delivery of three cases of sherry."
- (2) **PARTIAL**, *e.g.*, a bill drawn for £1,000, but accepted for £500 only.
- (3) **LOCAL**, *i.e.*, where a bill is accepted payable at a specified place only.
- (4) **QUALIFIED AS TO TIME**, *e.g.*, a bill drawn payable three months after date accepted payable six months after date.
- (5) **ACCEPTANCE BY SOME OF SEVERAL DRAWEES**.

DISCHARGE OF A BILL

A bill is said to be discharged when all rights and liabilities on it are nullified. There are five ways in which a bill may be discharged, namely:

- (1) **BY PAYMENT IN DUE COURSE**, *i.e.*, by payment made at or after the maturity of the bill by the acceptor to the holder thereof in good faith and without notice that his title to the bill is defective (if such is the case): *s.* 59 (1).
- (2) **WHEN THE ACCEPTOR BECOMES THE HOLDER OF THE BILL IN HIS OWN RIGHT AT OR AFTER MATURITY**: *s.* 61. Where a bill is negotiated back to the drawer or acceptor or prior endorser, such party may reissue and further negotiate the bill but cannot sue any intervening party to whom he was previously liable: *s.* 37.
- (3) **BY RENUNCIATION**, when the holder of a bill at or after its maturity absolutely and unconditionally renounces *in writing* his rights against the acceptor: *s.* 62 (1).
- (4) **BY CANCELLATION**, where a bill is intentionally cancelled by the holder or his agent, and the cancellation is apparent thereon: *s.* 63 (1).
- (5) **BY MATERIAL ALTERATION**, (*s.* 64), without the assent of all parties liable, in which case if the bill is in the hands of a holder in due course, he may use the bill as if it had not been altered and enforce payment according to the original terms of the bill.

DISHONOUR OF A BILL

When a bill has been duly presented for acceptance or payment in accordance with the rules laid down in the *Bills of Exchange Act*, and acceptance or payment has been refused or cannot be obtained, the

bill is said to be dishonoured by non-acceptance or non-payment. Upon such dishonour an immediate right of action accrues to the holder against all parties to the bill, provided the necessary formalities specified in the Act have been carried out. In most cases it is necessary for the holder to give formal notice of dishonour to all parties whom he is seeking to hold liable.

DISCOUNTING BILLS

The holder of a bill of exchange, who does not wish to wait until maturity before he receives the proceeds, may *discount* it and so obtain the funds immediately. To discount a bill is to sell (or negotiate) it. The discounter becomes a holder in due course, and can deal with the bill as he likes; his title to the bill is absolute and covers the whole face value. Of course, no banker will discount a bill unless he is satisfied that the parties thereto are of good standing; otherwise he may risk losing his money entirely. But if he decides to discount or buy a bill he may enforce payment against any party liable on the instrument if it is dishonoured. If a discounted bill is returned unpaid, the banker can debit the customer with the amount thereof and with any charges incurred in connection with the dishonour.

When a customer takes a bill to his bank to be discounted the banker buys the bill for an amount less than its face value. *The margin between the face value and the amount paid by the bank, i.e., the proceeds of discounting, is termed banker's discount*, and is calculated by the banker as interest on the amount of the bill for the period the instrument has to run.

Actually, the amount received by the customer is less than the *true present worth*, or true present value of the bill, *i.e.*, that sum which, with interest added for the time the bill has to run, would equal the amount of the bill. In other words, *banker's discount is in excess of true discount*.

For example, on 4th January, 19 . . , a customer may present a bill for £1,000 to his bank for discount. The bill is due on 18th March 19 . . , and the bank may agree to discount the bill at 10 per cent. He calculates as follows:

$$\begin{aligned}\text{Discount at 10 per cent for 73 days on } \pounds 1,000 &= \pounds 20 \\ \pounds 1,000 - \pounds 20 &= \pounds 980.\end{aligned}$$

The bank will therefore pay the customer £980 for his bill. If the bank reckoned *true discount*, he would proceed as follows:

Assuming P.W. to represent the present value of a bill which in 73 days at 10 per cent per annum would amount to £1,000:

$$\text{P.W.} = 1 + \left(\frac{10 \times 73}{365 \times 100} \right) = \text{£}1,000:$$

$$\text{i.e., P.W.} = \text{£}1,000 \left(\frac{100}{102} \right)$$

$$\text{i.e., P.W.} = \text{£}980.39$$

$$\therefore \text{True discount } \text{£}19.61$$

In other words, by the method of calculating bankers' discount the banker gains a small margin and his customer loses to the same extent.

PROMISSORY NOTES

Promissory notes are in many ways similar to bills of exchange, but differ in certain important respects. They are governed, like bills, by the *Bills of Exchange Act 1882*, which by s. 83 defines a promissory note as:

"An unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to bearer."

From this definition it will be obvious that a note is not "drawn" but *made*, and the person who first puts his name to it and issues it is known as the "maker". Since promissory notes are never accepted there can be no acceptor; his place is taken by the maker, who is the party primarily liable on the instrument. The remaining parties to a note are in a position similar to the other parties to a bill (endorsers).

A promissory note is inchoate and incomplete until its delivery to the payee or bearer.

No 44

£500

Blank Street,
Southpool
4th March, 19..

TWO MONTHS after date I promise to pay Anthony Hampton or order the sum of Five hundred pounds, for value received.

(signed) A.B. Wells

DIFFERENCES BETWEEN BILLS OF EXCHANGE AND PROMISSORY NOTES

The following are the principal points of differences between the two classes of instruments:

Bill of Exchange

The drawer of a bill when it has been accepted is only secondarily liable.

A bill is an *order* to pay.

Bills are accepted if payable other than on demand.

Bills may be accepted conditionally.

Acceptors of a bill are liable jointly.

Promissory Note

The maker of a note is the principal debtor, and corresponds with the acceptor of a bill.

A note is a *promise* to pay.

Notes are *never accepted*—there is no drawee.

Notes cannot be made conditionally. Makers of a note may be liable jointly or jointly and severally, according to its wording.

I.O.U.s

An I.O.U. which does no more than acknowledge the existence of a debt is *not* a negotiable instrument. It is merely evidence of an account stated with an implied promise to pay. But if the I.O.U. contains promissory words it may be a promissory note and, therefore, negotiable.

CHAPTER THIRTY-FOUR

Cheques

A cheque is a *bill of exchange drawn on a banker payable on demand* (*Bills of Exchange Act* 1882, s. 73). As will be seen from this definition, a cheque is merely a special form of bill of exchange, and, in general, the provisions of the *Bills of Exchange Act* governing bills apply also to cheques. There are, however, a number of points in which the law relating to cheques differs from that relating to other bills of exchange.

“STALE” CHEQUES

So far as the drawer's liability is concerned, s. 45 (2) of the *Bills of Exchange Act* (see page 437) does not apply to cheques, which are governed by s. 74 (1). This provides that where the drawer of a cheque suffers damage through delay in its presentment, *e.g.*, by the failure of the bank on which the cheque was drawn and at which there were funds to meet it, he is discharged to the extent of such damage. In such a case, the holder of the cheque becomes a creditor of the banker to the extent to which the drawer was discharged. In the absence of such damage, the drawer of a cheque remains liable on it for six years after its issue, but it is the practice of bankers to return “stale” cheques which from the date on them appear to have been in circulation for more than six months.

For purposes of *negotiation*, a cheque (like any other bill on demand) is deemed to be overdue when it has been in circulation for an unreasonable time. What is an unreasonable time for this purpose is a question of fact.

POST-DATED AND ANTE-DATED CHEQUES

Cheques are sometimes drawn bearing a date subsequent to the actual date of issue. They are then said to be *post-dated*. The object of post-dating (when it is intentional) is usually to delay payment pending collection of funds against which the cheque is drawn, or it may be that the drawer does not wish the payee to receive payment until a later date. The banker on whom such a cheque is drawn will not pay it until the date marked on it and will usually return it to the bank by which it was presented for payment.

Ante-dated cheques are those which bear a date earlier than that on

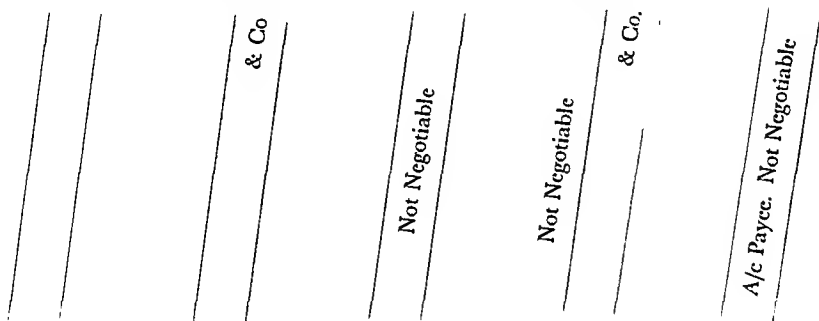
which they are issued. This usually occurs by accident and has no practical effect other than to cause the cheque to appear to be stale or overdue.

By s. 13, *Bills of Exchange Act*, a cheque is not invalid by reason only that it is post-dated, ante-dated or bears the date of a Sunday. In the latter case, or when the date is that of a public holiday, the cheque will not be paid by the banker on whom it is drawn until the first business day following the date on the cheque.

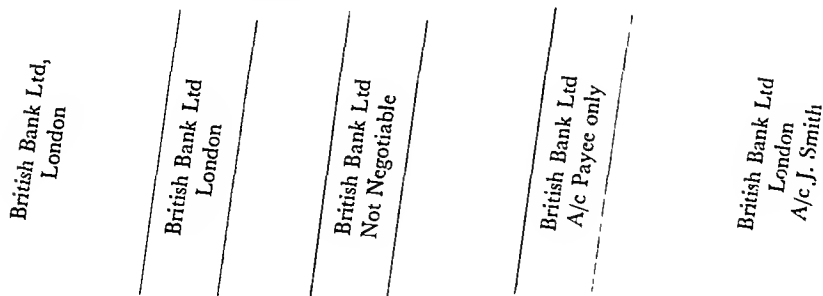
CROSSED CHEQUES

Amongst the methods adopted to make cheques a safe form of payment, crossing is perhaps the most important. A crossing may be either *general* or *special*.

SPECIMENS OF GENERAL CROSSINGS



SPECIMENS OF SPECIAL CROSSINGS



GENERAL CROSSING. Where a cheque bears across its face (a) the words "*and company*", or any abbreviation thereof, between two parallel transverse lines, or (b) two parallel transverse lines simply, in either case with or without the words "*not negotiable*", that addition constitutes a crossing, and the cheque is crossed *generally*: s. 76 (1).

SPECIAL CROSSING. Where a cheque bears across its face an addition of the name of a banker (mentioning it may be a particular branch of the bank concerned) either with or without parallel lines or the words "*not negotiable*", that addition constitutes a crossing, and the cheque is crossed *specialy* and to that banker: *s.* 76 (2).

The paying banker must pay the amount of a cheque with a *general crossing* only to a banker and he must pay a cheque with a *special crossing* only to the banker named or to the latter's agent for collection, being a banker. In no case may a banker pay a crossed cheque over the counter or a cheque crossed specially to anyone other than the banker named or his agent, otherwise the paying banker is liable to the true owner for any loss sustained by the latter owing to the cheque having been so paid (*s.* 79). But where a banker pays a cheque on which a crossing has been altered or obliterated, and the alteration or obliteration is not apparent, he is protected by the same section from liability both to his customer and to the true owner.

An uncrossed or "open" cheque may be paid across the counter provided any endorsements appear to be in order.

"NOT NEGOTIABLE" CROSSINGS. Where a person takes a crossed cheque which bears on it the words "*not negotiable*", he can neither obtain for himself nor give to anyone else a better title to the cheque than was possessed by the person from whom he took it: *s.* 81.

In other words, a cheque crossed "*not negotiable*" loses its natural quality of negotiability, and if it is lost or stolen, no person, other than the true owner, can acquire a good title to it.

NOT TRANSFERABLE CHEQUES

The fact that a cheque is crossed "*not negotiable*" does not in any way restrict its transferability; the only effect of the words is to cause any defect in the title of a holder to affect all subsequent holders. The best ways in which a bill or cheque may be made non-transferable are by drawing it in the form "*Pay X only*" or by writing across its face the words "*not transferable*", with the words "order" or "bearer" struck out (if they appear on the cheque form). A bill or cheque in either of these forms is absolutely incapable of valid transfer.

"OPENING" A CROSSING

Where a trader desires to make a payment by an uncrossed (or "open") cheque, but all the cheque forms in his cheque book bear printed crossings, or where he has sent a crossed cheque to a creditor and the latter intimates to him that he has no banking account and therefore desires an "open" cheque so that he may cash it over the

counter, the trader may "open" the crossing on any such cheque by writing against the crossing the words "Please pay cash", accompanied by his full signature.

ALTERATION OF CHEQUES

Sometimes the drawer of a cheque may wish to alter it after he has written it out; in such circumstances he should append his full signature to any alterations he makes. In practice, however, banks will usually accept the drawer's initials as sanction for minor alterations.

If a cheque is materially altered without the consent of the drawer, the provisions of s. 64 of the *Bills of Exchange Act* apply (see page 437). But, since the customer of a bank is under an implied obligation to use reasonable care in drawing cheques so as not to involve his banker in any loss directly traceable to carelessness on his part, he cannot deny the right of his banker to debit him with the full amount of a cheque where that amount has been fraudulently raised and the alteration has been facilitated by the customer's negligence, as where he has left blank spaces when filling in the cheque.

This principle applies also to other alterations. Consequently, the customer should fill in his cheque so as to render difficult *any* alteration (*e.g.*, in the payee's name).

"BLANK" CHEQUES

It frequently happens that a person wishes to send a cheque in payment of a debt the exact amount of which he does not yet know. For this purpose he may send what is known as a *blank* cheque, *i.e.*, one drawn in the usual way, but with the amount blank, so that the payee may fill in the cheque for the requisite amount. The issue of a cheque lacking in any material particular in this way acts as authority to the holder to fill it up as he thinks fit (s. 20, *Bills of Exchange Act* 1882). As a safeguard against fraud in such cases, it is usual for the drawer to mark the cheque with a limit to the amount for which it is to be drawn, as by writing words such as "under ten pounds" or "not over five pounds" across the top or by the side of the crossing.

REMITTANCE OF CHEQUES BY POST

In remitting cheques by post, the sender should take all practicable precautions against any loss that may arise from miscarriage or theft. Even if the carrier is the agent of the recipient, the sender must, if he

is to protect himself, comply with any instructions given him by the addressee as to the manner in which the cheques are to be made out. He should, therefore, take all possible precautions. Where the carrier is the agent of the remitter, the latter is not deemed to have paid his debt (even conditionally) until the cheque comes into the hands of the payee, and, if the cheque be lost or stolen in course of transit, he runs the risk that the cheque may be paid by his banker on presentation by some person other than the payee or true owner, in which case the banker will probably be able to debit the drawer's account, although the drawer will still remain liable to the payee.

Unless the creditor makes a stipulation to the contrary, any cheque remitted through the post should be drawn payable to order and not to bearer. As has been seen, a cheque payable to order cannot be validly negotiated until it has been endorsed by the payee; if a cheque so drawn is stolen, it is necessary for the thief to forge the payee's endorsement, and this forgery will prevent the passing of a good title. But even so, the cheque may be presented and paid before the drawer has been notified of the loss and has had an opportunity of countermanding payment.

As an additional safeguard, therefore, all cheques sent through the post should be crossed. This affords a measure of security in that a crossed cheque can be paid only through the medium of a bank; and bankers will not usually collect cheques except on behalf of persons known to them. Moreover, where the name of the payee's bank is known, the cheque should be crossed *specially* to that bank.

The addition of the words "not negotiable" to the crossing affords little additional security to the drawer in the case of a cheque payable to order, but is a very valuable safeguard where it is desired to send by post a cheque payable to bearer or one on which the last endorsement is in blank.

Such words as "Account Payee", "Account A.B.", "Inland Revenue Account", are sometimes added to the crossing on a cheque. Such additions have no statutory recognition, but are an additional safeguard inasmuch as they clearly constitute a direction to the collecting banker to place the proceeds of any cheque so marked only to the account named and disregard of such instructions will constitute negligence sufficient to deprive him of his statutory protection in the event of an action against him for conversion.

PAYMENT BY CHEQUE

Where a debtor hands to a creditor a bill or cheque in payment of a debt, discharge of the bill or cheque operates as a discharge of the debt. If a cheque for a smaller amount than the debt owing is

accepted and is duly paid, it is a partial discharge only, unless a new agreement supported by consideration releases the debtor from payment of the balance.

But until the bill or cheque is discharged, it operates as a *conditional* payment only, unless, of course, the creditor agrees to take it in final payment. The condition attaching to the payment is that the debt will be revived if the bill or cheque is not duly honoured on presentment to the drawee. But until the instrument has been duly presented and dishonoured, the creditor's right of action against the debtor is suspended. On dishonour the creditor may sue either on the debt or on the bill or cheque. In the case of a bill other than a cheque, delay in presentment will also discharge the drawer and endorsers from liability in respect both of the bill and of the consideration for which the bill was given, but delay in the presentment of a cheque will not discharge the drawer except so far as he has suffered damage by the delay.

A paid cheque constitutes good evidence of payment, usually obviating the need for a formal receipt. A formal receipt, however, can still be legally demanded and must then be given.

THE PAYING BANKER

Since the obligation to honour cheques is one of the foremost duties owing by a banker to his customer, it is imperative that all persons opening banking accounts should have an exact knowledge of the nature and extent of this obligation, and of the duties and liabilities of both banker and customer.

THE BANKER'S DUTY TO PAY CHEQUES

A banker is bound to honour cheques drawn by his customer to the extent of the latter's credit balance on current account, or to the limit of an agreed overdraft, *provided that* (a) the cheques are drawn in correct and unambiguous form, and purport when presented by the holder in person to be properly endorsed, and (b) that there is no circumstance which legally releases the banker from his duty or authority to pay.

TERMINATION OF THE BANKER'S DUTY

The banker is released from his duty to pay cheques in the following circumstances:

- (1) Where the customer has countermanded payment.
- (2) Where the banker has received notice of the death or insanity of the customer.

- (3) When a receiving order is made against the customer, or when the banker receives notice of the presentation of a bankruptcy petition against the customer. On receipt of reliable notice that his customer has committed an available act of bankruptcy, the banker may refuse to honour cheques presented by anyone other than the customer himself.
- (4) In the case of a registered company, the presentation of a winding-up petition or the passing of a resolution to wind up.
- (5) Notice that the customer is an undischarged bankrupt.
- (6) Service of a court order attaching the customer's credit balance.
- (7) Notice of an assignment by the customer of his credit balance.
- (8) Notice that the customer is applying the funds in breach of a trust.
- (9) Notice of a defect in the title of the person presenting the cheque.

COUNTERMAND OF PAYMENT

It has already been pointed out that a banker's duty to pay his customer's cheque is terminated on receipt of instructions from his customer countermanding or "stopping" payment, as may happen, for example, where a trader who has sent a cheque to a creditor in payment of a bill notifies the bank that the cheque has been lost, and gives the bank instructions to pay the cheque. If the cheque is thereafter presented for payment, it will be returned with the answer, "Orders not to Pay", "Payment countermanded" or "Refer to Drawer".

In this way there is some protection against loss by theft, for if the cheque were unendorsed when lost it can be negotiated only under a forgery, in which case the transferee will get no title and will be unable to sue the drawer for the amount of the instrument. If, however, the cheque before loss were drawn payable to bearer or endorsed in blank, the bearer (unless he is the finder or thief) has every right to payment and can compel the drawer to pay, unless the cheque when lost was crossed "not negotiable", in which case the bearer gets no title.

Thus, the object of stopping a cheque is to prevent the thief or finder from obtaining payment. The stopping must therefore be performed as soon as possible, but the only person entitled to countermand payment is the drawer. An endorser who has lost the cheque has no such right: his best course is to inform the banker of what has happened and at the same time to inform the drawer, so that the latter may stop payment. If this is done and the cheque is presented to the banker before he has heard from the drawer, he will usually postpone payment pending confirmation from the latter.

In stopping a cheque the drawer should be very careful to give the exact description of the instrument to the banker. The chief details are the number, amount, name of payee and date. Should he by mistake give the banker the wrong number, he will not be able to make any complaint because his banker stops the wrong cheque and pays the one which should have been stopped. The number is the most important detail.

Provided, however, that correct instructions are given to the banker, the latter must obey them, and if he ignores them and pays the cheque he will have no right to debit his customer.

FORGERY OF DRAWER'S SIGNATURE

If a banker pays a cheque on which the *drawer's* signature is forged, he cannot normally debit the customer's account with the amount of the cheque, since he has paid away the money without his customer's authority. The only exception was provided by s. 24 is where the customer is precluded from pleading that the signature was a forgery, *i.e.*, where the customer by his own conduct (and mere negligence is not sufficient) holds out or impliedly represents to the banker that the forged signature is in fact his own; in such circumstances he would be *estopped* denying the existence of the forgery and thus the banker could debit the customer's account with the cheque bearing the forged signature.

FORGERY OF AN ENDORSEMENT

Where the banker pays a cheque on which the payee's or an endorser's signature has been forged, such payment would not, in the absence of statutory provision to the contrary, operate as a payment in due course, discharging the cheque and giving the bank a right to debit his customer's account. Moreover, the banker would be liable to the true owner for conversion, *i.e.*, wrongfully dealing with an instrument belonging to that true owner.

But since it is obviously impossible for any banker to verify the authenticity of the endorsements on all cheques presented to him, statutory protection in this respect is afforded him by s. 60, *Bills of Exchange Act*. This section provides that a banker who, in good faith and in the ordinary course of business, pays a cheque drawn upon him, is deemed to have paid the cheque in due course (and so to be entitled to debit his customer), notwithstanding that the payee's endorsement or any subsequent endorsement is forged or unauthorised. In regard to crossed cheques, s. 80 protects a banker from liability to the true owner if he pays in good faith, without

negligence, and in accordance with the terms of the crossing, a crossed cheque that has fallen into wrong hands or that bears a forged endorsement. S. 80 also protects the drawer against any further claims against him, if the cheque has come into the payee's hands.

"MARKING" CHEQUES

A cheque is said to be "marked" when it bears the signature or initials of the drawee banker, sometimes accompanied by words such as "Good for payment if presented before" Such a marking indicates that the cheque will be duly honoured when ultimately presented for payment.

Cheques are most commonly marked in this manner at the request of the collecting banker, when they are received too late in the day for clearance through the usual channels. Such marking constitutes constructive payment and imposes on the drawee banker an obligation to pay the cheque when re-presented. The drawer cannot, therefore, countermand payment of a cheque so marked.

Cheques are also sometimes marked by the drawee-bank at the request of the drawer in cases where the payee has asked for some token that the cheque will be paid on presentment, as where it is tendered in exchange for title-deeds to land. In these circumstances, it would be better for the customer to obtain from his banker in exchange for the cheque a banker's draft made out to the order of the payee.

THE COLLECTING BANKER

PROTECTION OF THE COLLECTING BANKER

Where a banker receives payment for a customer of a cheque crossed generally or specially to himself, and the customer has no title or a defective title thereto, the banker is protected from liability to the true owner of the cheque if he collects it in good faith and without negligence: *s. 4, Cheques Act 1957*.

In the absence of this protection, the banker would be liable to the true owner of the cheque for conversion of his property. To obtain the protection, the banker must show that:

- (a) The instrument is one to which the section applies, *e.g.*, cheques, banker's drafts, certain revenue orders and instruments which, although not bills of exchange, are intended to enable one to obtain from the banker payment of a specified amount.
- (b) The instrument was collected by the banker himself for a

customer, or for himself, having already credited the customer with such instrument.

- (c) The instrument was collected *in good faith and without negligence*.

NEGLIGENCE

The general test of negligence upon the part of a banker who collects a cheque is whether the circumstances surrounding the payment-in of the cheque were such *as to put a reasonable man upon inquiry*. It follows that no hard-and-fast rules can be laid down as to what constitutes negligence, since this is a matter to be determined upon the facts of each case. Nevertheless, the following circumstances in which the Courts have held bankers to be negligent illustrate the general principles which are applied:

- (1) Collection for the private account of a company official of cheques payable to the company and endorsed by him as agent of the company.
- (2) Omission to obtain and follow up a reference from a new customer.
- (3) Collection of a cheque crossed "Account payee" for a person other than the payee named.
- (4) Collection for the private account of a customer of a cheque drawn by him, or by him and another, on behalf of his firm or company.
- (5) Omission to verify the authority of a person signing *per pro* in suspicious circumstances.

ENDORSEMENT OF CHEQUES

It is important that all persons negotiating cheques should ascertain that any endorsements appearing on them are correct in form, as any irregularity in this respect will result in delay in obtaining payment, and, as has already been shown, may deprive a collecting banker of his statutory protection.

GENERAL RULES GOVERNING ENDORSEMENTS

An endorsement must be written on the bill or cheque itself. It must consist of a signature in proper form, which must be spelt in the same way as the name of the payee on the face of the instrument, or of the endorsee of the last special endorsement, and must include the same Christian name or initials; though where the payee's Christian name is expressed, initials will serve in the endorsement, and *vice versa*.

Courtesy descriptions or titles must not appear *as part of the signature*, although they may follow it by way of description of the person signing.

If the payee is incorrectly described in the body of the instrument, he should endorse correspondingly, adding, if he thinks fit, his usual signature.

CHAPTER THIRTY-FIVE

The Banking System—I:

The Bank of England

A characteristic institution of the commercial sector of an advanced market economy is a banking system, which generally comprises commercial banks and a central bank. The British banking system includes a central bank (the Bank of England), deposit (clearing) banks, merchant banks, the National Savings Bank, the British offices of overseas banks and other financial institutions.

There is no precise statutory definition of a banker or banker. Thus, the *Bills of Exchange Act* 1882, s. 2, refers to a bank as “any body of persons whether incorporated or not, who carry on the business of banking”. In general, an institution is recognised as a bank if its principal activities include the acceptance of money on current account, the collection of cheques on behalf of customers and payment of cheques or orders drawn on it by a customer.

CENTRAL BANKS

Central banks, which, in some countries, are nationalised, are bankers to their governments, are partially responsible for implementing national credit and monetary policies and are “lenders of last resort” to the commercial banks. Essentially, they are public institutions which, by a process of evolution or specific functional design stand at the very centre of credit creation and regulation. An example of a specifically designed institution of this nature is the U.S. Federal Reserve System; an example of an institution which has evolved in response to the need for a central instrument of credit control is the Bank of England.

CREATION AND DEVELOPMENT OF THE BANK OF ENGLAND

The Bank was established by Act of Parliament and Royal Charter in 1694, under which the 1,268 subscribers to its capital stock became incorporated as “the Governor and Company of the Bank of England”. In 1697 its capital was increased and its charter was extended to 1711; after that date it was renewed periodically. By the mid-eighteenth century it was receiving funds on deposit, circulating Exchequer Bills, managing the issue of government securities and administering the National Debt.

The important *Bank Charter Act* 1844 included the following provisions: no further note-issuing banks were to be created and existing banks were to lose the right of note issue on bankruptcy, amalgamation or opening in the London area; the Bank of England was to have two separate departments, the Issue Department and the Banking Department and a weekly return of both Departments was to be issued weekly. In 1928 the Bank emerged as the sole note-issuing authority.

In 1946 the Bank was nationalised. Its capital stock was brought into public ownership and its shareholders were compensated by the receipt of government stock.

INTERNAL ORGANISATION OF THE BANK

Control of the Bank is exercised nominally by the Court of Directors, which comprises the Governor, Deputy Governor and sixteen Directors appointed by the Crown. The Court is required by Charter to meet once a week—traditionally on Thursdays. Day-to-day administration is carried out by heads of departments, the senior of whom is the Chief Cashier; in effect he is the Bank's chief executive officer. The Cashier's Department is concerned with administering the note issue, the banking functions, the Exchange Equalisation Account, etc.

The Accountant's Department maintains registers of government stocks, etc. The Economic Intelligence Department reports on the domestic economy and the balance of payments. The Overseas Department is concerned with relations with overseas central banks and, in particular, the Sterling Area. The Exchange Control Department administers affairs arising from the *Exchange Control Act* 1947, which was designed to protect the country's official reserves. The Audit Department audits the Bank's assets, examines procedures and is responsible directly to the Governors.

FUNCTIONS OF THE BANK OF ENGLAND

The Bank's functions, which derive fundamentally from its concern with the nation's money and credit, have evolved over the centuries; they have not emerged from the provisions of one particular statute. It is important to remember that the Bank is *not* a government department; but in the exercise of the functions set out below it mirrors faithfully current government financial policies.

BANKERS TO THE GOVERNMENT

The Bank administers the Government's main accounts. The

National Loans Fund, created in 1968 to raise additional central government funds and to meet National Debt management and interest charges of the National Debt, is managed by the Bank.

Where government revenue has been collected it will generally pass through the central Exchequer account which is kept at the Bank. The Government's receipts are usually credited to this account and payments by the government have their origin there.

BANKERS TO THE BANKING SYSTEM

The Bank acts as banker to the commercial banks and, in effect, as lender of last resort to the discount houses. The commercial banks keep their accounts with the Bank; the discount and accepting houses and many London branches of overseas banks also keep accounts there. The London clearing banks keep a substantial proportion of their cash holdings as balances at the Bank; from these they settle cheque and credit clearings with one another.

The Bank exercises a considerable measure of control over the commercial banks. This matter is discussed on pages 456–9.

BANKERS TO OTHER CENTRAL BANKS AND MONETARY AUTHORITIES

Nearly one hundred overseas central banks have accounts with the Bank of England. Accounts are kept also for institutions such as the International Monetary Fund, the International Bank for Reconstruction and Development and the Bank for International Settlements.

BANKERS TO PRIVATE CUSTOMERS

A small number of private accounts is handled by the Bank. These include some individuals and private bodies who have had long and close associations with the Bank. Members of the Bank's staff are offered its banking facilities.

NOTE-ISSUING AUTHORITY

The Bank of England is now the central note-issuing authority. Its note issue is now completely *fiduciary*, i.e., it is backed by government and other securities, not by gold. Today's fiduciary issue stands at £7,000 million. Profits of issue of notes which are the Issue Department's earnings on holdings of securities less operational costs, are paid into the National Loans Fund.

The amount of notes in circulation reflects the public demand for

money. The Bank is concerned, however, not so much with the total note circulation as with the total supply of money; in that total supply, bank deposits are of much more importance than notes.

REGISTRAR AND MANAGER OF STOCKS

The Bank acts as registrar of Government stocks and of stocks issued by the nationalised industries. It manages also stocks of some Commonwealth governments, public boards and local authorities. It has been estimated that, in the exercise of this function in any one year, the Bank is involved in four million dividend payments and over 700,000 stock transfers.

AGENT FOR THE GOVERNMENT

The Bank administers exchange control, on behalf of the Government, manages the Exchange Equalisation Account and conducts operations in gold and foreign exchange so as to implement government decisions. See the *Exchange Equalisation Account Act 1979*.

In its relations with the commercial banks the Bank of England acts, not only as a channel of communication, but as a direct agent, as, for example, where it issues directives relating to commercial banking practice.

FINANCIAL ADVISOR

The Bank's unique position as recipient of economic intelligence, together with its intensive daily involvement in the money and foreign exchange markets, enables it to provide advice to the Treasury and other government departments, to commercial banks and other financial institutions and to industry and commerce in general. The Bank's links with international bodies, such as I.M.F. and O.E.C.D., enable it to prepare and issue forecasts on matters concerning the balance of payments, the strength of sterling and general international financial development.

THE BANK AND MONETARY POLICY

The Bank's role as guardian of the monetary system is seen best in its activities which are designed specifically to control the volume of credit. To this end it operates four regulators by means of which it is able to control the lending activities of the commercial banks. These regulators are based on: changes in the minimum lending rate; open market operations; calls for special deposits from the banks; specific directives to the banks.

By means of these regulators, as will be seen below, the Bank of England is able to affect the supply of money in accordance with government policy. A government may decide, for example, that the rate of inflation can be diminished only by a reduction in the volume of money in circulation and by a contraction of effective purchasing power. The Bank will, in pursuit of this policy, so act as to reduce the volume of bank deposits, which, because they are convertible without restriction into cash, are considered by their owners, effectively, as cash. Probably 90 per cent of the entire volume of business payments in Britain is made by cheques, which are drawings on bank deposits; hence their significance in credit control.

Official definitions of money are denoted by the symbols M_1 and M_3 ; the symbol M_2 is no longer in use. M_1 comprises notes and coins in circulation + current bank accounts. M_3 comprises M_1 + bank deposit accounts. Where reference is made in official statistics to "volume of money in circulation" it is important to know precisely the definition of money which has been adopted.

MINIMUM LENDING RATE

M.L.R. replaced Bank Rate following an announcement by the Chancellor of the Exchequer in October 1972. Doubts had been expressed and articulated by the Radcliffe Report as to the effectiveness of Bank Rate—the minimum rate at which the Bank would advance money on first-class bills. In theory, a rise in Bank Rate would be followed by an increase in the discount rate of the commercial banks, a transference of funds to London from abroad to gain advantage from increased interest rates, an increase in bank deposits which would reduce consumer demand and reinforce the tendency for prices to fall, the stimulation of exports and fall in imports. In general, the demand for money would fall. A fall in Bank Rate would, in theory, have opposite effects.

The Chancellor's statement referred to a decline in the role of Bank Rate in the determination of the structure of interest rates. A new rate was needed which would respond in a flexible manner to altered conditions in the money market and whose movements would not be interpreted invariably as heralding basic shifts in government financial policy. M.L.R. was to be fixed weekly at $\frac{1}{2}$ per cent above the average discount rate for Treasury bills; in practice it is rounded to the nearest $\frac{1}{2}$ per cent above. The main influence of M.L.R. is exerted on the short-term interest rate; it does not necessarily exert a major influence on all interest rates.

A further reform of monetary policy aimed at credit control was introduced in September, 1971, which required all banks—not only the

clearing banks—to maintain a minimum reserve assets ratio of $12\frac{1}{2}$ per cent between eligible reserve assets and eligible liabilities. “Eligible reserve assets” comprise a bank’s liquid assets (*e.g.*, cash, balances at the Bank of England, excluding till money and special deposits); money at call; Treasury bills; approved commercial bills. “Eligible liabilities” are sterling deposit liabilities.

OPEN MARKET OPERATIONS

Operations of this nature are undertaken when the Bank’s agents buy or sell securities on the money markets. The objectives of these operations are three-fold: first, to implement government monetary policy; second, to ensure the availability of short-term finance to meet government expenditure; third, to maintain the liquidity of the entire banking structure.

Assume, for example, that the Bank, in response to government policy, wishes to act so as to restrict the total volume of credit. It will sell Treasury bills (generally issued by the Government in units of £5,000 and £10,000 for periods of up to 91 days) in payment for which buyers will draw on their accounts with the commercial banks. The result will be a reduction in the banks’ reserves and a curtailing of their ability to make loans. The general result is the desired reduction in purchasing power. When the Bank buys securities an opposite effect will follow.

SPECIAL DEPOSITS

The Bank of England is empowered to call, with Treasury approval, for all banks to place with it special deposits equal in volume to a stated percentage of the eligible liabilities of each bank. Since these deposits will be made from the banks’ cash reserves, the Bank, in calling for them, is able effectively to reduce the banks’ powers to create credit.

In December 1973 the Bank brought into use a scheme of supplementary deposits which embraced all banks and all financial houses which accepted deposits. Under the scheme supplementary deposits, which would not earn interest, unlike special deposits, would be placed with the Bank whenever the sterling deposit liabilities of the banks of financial houses rose above a stated level. In effect, credit creation could be restricted further.

SPECIAL DIRECTIVES

Under the *Bank of England Act 1946* the Bank is empowered to “request information from and make recommendations to bankers

...” and, on the basis of Treasury authorisation, to “issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation”.

THE WEEKLY BANK RETURN

The Bank's Weekly Return consists of two balance sheets; one concerns the Issue Department; the other, the Banking Department. The Return is compiled at the end of business each Wednesday; it is issued for publication following the meeting of the Court on Thursday; it is published in the London Gazette and the national press on Friday.

EXAMPLE OF THE WEEKLY RETURN

Published February 24th, 1978

BANKING DEPARTMENT

<i>Liabilities</i>	£
Capital	14,553,000
Public Deposits	24,081,879
Special Deposits	1,229,300,000
Bankers' Deposits	384,298,157
Reserves and Other Accounts	677,564,990
	<hr/>
	2,329,898,026
	<hr/>
<i>Assets</i>	£
Government Securities	1,981,171,088
Advances and Other Accounts	180,522,446
Premises, Equipment and Other Securities	159,716,703
Notes	8,311,740
Coin	176,049
	<hr/>
	2,329,898,026
	<hr/>

ISSUE DEPARTMENT

<i>Liabilities</i>	£
Notes Issued	7,700,000,000
In Circulation	<hr/>
In Banking Department	7,691,688,260
	8,311,740
	<hr/>
<i>Assets</i>	
Government debt	11,015,100
Other Government Securities	6,607,187,904
Other Securities	1,081,796,996
	<hr/>
	7,700,000,000
	<hr/>

ITEMS IN THE BANK RETURN

Reference should be made to the Weekly Return illustrated on page 459.

BANKING DEPARTMENT

(a) *Liabilities*

- (i) *Capital*. This comprises the amounts subscribed by stockholders.
- (ii) *Public Deposits*. This figure is made up of the sums which stand to the credit of the central government's principal accounts, *e.g.*, the Consolidated and National Loans Fund Accounts, Savings Bank Accounts.
- (iii) *Special Deposits*. These deposits are explained on page 458.
- (iv) *Bankers' Deposits*. This figure comprises the commercial banks' balances which appear in their balance sheets as "Cash at the Bank of England".
- (v) *Reserves and Other Accounts*. The accounts of the Banks' other customers, including some overseas banks and a small number of private customers are included in this figure.

(b) *Assets*

- (i) *Government Securities*. This item is the largest asset and includes the Banking Department's investments in British Government stocks and Treasury bills.
- (ii) *Advances and Other Accounts*. This item comprises the amount of the Bank's lending to the money market, *e.g.*, by the rediscounting of bills, advances by overdraft or loan to the Bank's customers.
- (iii) *Premises, Equipment and Other Securities*. Other Securities indicate the Bank's purchases of bonds and other securities on the Stock Exchange or in the discount market.
- (iv) *Notes*. The Bank's reserve of notes from which the commercial banks draw is represented by this item.
- (v) *Coin*. The Bank's reserves of coin from which the commercial banks draw is represented by this item.

CHAPTER THIRTY-SIX

The Banking System—II:

The Commercial and Other Banks

A notable feature of the history of British commercial banks in the present century has been the drive towards concentration by amalgamation and absorption, whereby the banking business of the country became centred in a few large institutions, the "Big Five"—the Midland, Lloyds, Barclays, the Westminster and the National Provincial Banks. In 1968 further mergers took place, *e.g.*, the National Provincial with the Westminster, and Barclays with Martins. There are now four groups: Barclays, the National Westminster, the Midland and Lloyds.

The merging process was carried out in three principal ways:

- (1) The absorption by large provincial banks of small country banks.
- (2) The absorption by large provincial banks of smaller London banks.
- (3) The amalgamation of large banks to take advantage of the economies of large-scale organisation.

The commercial banks have interests in overseas banks and in hire purchase finance. Each has a large number of branches.

BRANCH BANKING

Side by side with this process of amalgamation and absorption, there has been in England and Wales a vast extension of the system of branch banking, whereby the great banks operating from London have set up control on a regional basis and established a network of branches throughout the provinces under local managers. Although this system has disadvantages, it has a number of advantages:

- (1) It facilitates the transfer of capital from districts where there is a surplus to those where there is a deficiency. It also permits the movement of funds according to seasonal needs in various districts.
- (2) The specialised skill and knowledge of the Head Offices of the large banks are available for customers in all parts of the country.
- (3) Banking facilities are made available in small towns, etc., where the establishment of a local bank might not be a paying proposition.

Of the disadvantages attached to the system, the following may be mentioned:

- (1) The control of branches by Head Office which has little knowledge of local affairs tends to restrict the effectiveness of branch managers. This disadvantage is largely overcome in some banks by the establishment of District Head Offices with local directors.
- (2) Intensive competition between a few large banks may lead to unnecessary waste, *e.g.*, the opening of several unprofitable branches in a district where one branch could adequately cope with all the banking business.

FUNCTIONS OF A COMMERCIAL BANK

The following are the principal functions of a commercial bank:

- (1) THE RECEIPT OF DEPOSITS:
 - (a) *On Current (or Cheque) Account*, in which case funds are withdrawable on demand by cheque. No interest is usually paid on such an account.
 - (b) *On Deposit Account*, withdrawable after a specified period of notice. Interest is paid on such accounts.
 - (c) *On Home Safe or Savings Account*. The customer is allowed to place money in a small safe, which is periodically taken to the bank to be opened, and the proceeds credited to the customer's account.
- (2) GRANTING LOANS to customers, in the form either of a fixed or reducing advance on loan account or of a fluctuating overdraft on current account.
- (3) DISCOUNTING BILLS, *i.e.*, the purchase of bills of exchange at their face value less interest for the period which they have to run before maturity.
- (4) AGENCY SERVICES. In addition to the primary functions of borrowing and lending, a bank performs a number of agency services on behalf of its customers. These include:
 - (a) The collection and payment of cheques, bills, dividend warrants and other instruments.
 - (b) Stock and share transactions; investment management services.
 - (c) Assisting companies to raise capital.
 - (d) The periodical payment of subscriptions, insurance premiums, etc., on behalf of customers.
 - (e) The safe custody of valuables on behalf of customers.

- (5) MISCELLANEOUS SERVICES AND THE FINANCE OF FOREIGN TRADE, including:
- (a) The transaction of foreign exchange business, including the exercise of exchange control as agents for the Bank of England.
 - (b) The issue of various types of letters of credit, credit cards, bankers cards and travellers' cheques.
 - (c) Executor, trustee and personal tax services.
 - (d) Automatic cash dispensers—cash available at any time of the day or night—and *night safes*.
- (6) THE ISSUE OF NOTES. In England and Wales this function is confined to the Bank of England (but Scottish and Irish Banks issue notes for local circulation).

THE CLEARING SYSTEM

The growth of the cheque system led to the development of a mechanism whereby cheques can be exchanged in bulk and the resultant claims of each bank on other banks in respect of them can be set off and cancelled through one central agency, only the difference between the total sums that each bank has to pay or to receive being actually paid over. The primary function of a clearing is the transmission of cheques and documents; the setting-off of inter-bank debts is only incidental. In most towns there is a *local clearing* for the adjustment of the claims arising between the banks in that town, while in London there are the Town and the General Clearings, and in certain leading provincial towns (*e.g.*, Manchester) there are clearings that cover large provincial areas.

THE LONDON CLEARING HOUSE. The London Clearing House deals with cheques, bills, etc., payable by banks who are members of the *Committee of London Clearing Bankers*. (The Committee consists of the chairmen of Barclays, Coutts, Lloyds, Midland, National Westminster and Williams and Glyn's. It is through this committee that the Bank of England transmits policy communications to the banks.) Other London non-clearing banks (*e.g.*, the Scottish, Irish, Commonwealth and foreign banks) usually pass cheques, bills, etc., held by them to the credit of an account with one of the clearing banks.

The main cheque clearings of the London Clearing House are:

- (a) *The Town Clearing*, which deals with cheques, bills, etc., of £5,000 and over, payable at clearing banks in the central city area around the Bank of England.
- (b) *The General Clearing*, which deals with cheques payable at clearing banks outside the town area.

Each bank in the Clearing House sorts into separate bundles or "charges" all cheques drawn on other clearing banks, and a separate "charge" is made, in the case of each bank, for each section of the clearing. The items are then listed, and their totals agreed by the Clearing House representatives of the drawee banks who exchange their "charges".

Totals are made of all the cheques presented by or to each bank, and the difference between these totals represents the amount owing to or by each bank. A settlement is made each day by summarising the balances owing in respect of the Town Clearing for the same day, and the General Clearing for the last day but one, and the ultimate total owing to or by each bank is transferred in the books of the Bank of England between the account of that bank and the account of the Clearing House. Thus a few entries between these "master" accounts represent the aggregate of numerous lesser sums and a vast number of credits and payments, so involving an enormous saving in trouble, time and money.

RETURNS. In the case of the Town Clearing, any cheques dishonoured must be returned, on the day of presentment, direct to the Clearing House, and an adjustment made in the Town Clearing Sheet. In the case of the General Clearing, cheques must be returned direct by post to the bank named in the crossing.

On an average day in 1978, 4,100,000 cheques with a total value of £8,600 millions were exchanged and paid through Town and General Clearings.

A General Credit Clearing operates for the transmission of credit transfers.

The Bankers' Automated Clearing Services, a company wholly owned by the London Clearing Banks, receives money transfers recorded on magnetic tape and distributes them to appropriate banks.

THE BALANCE SHEET OF A COMMERCIAL BANK

On pages 465-466 is printed a balance sheet of the National Westminster Bank, Ltd, as at 31st December, 1977. Most of the items will require little explanation; the following points should, however, be noted:

(1) *Liabilities:*

- (a) *Capital.* This figure represents, in effect, claims due to the bank's shareholders.
- (b) *Current, deposit and other accounts.* This is the most important of the bank's liabilities and includes the amounts standing to the credit of the bank's customers on current and deposit account. It is not possible to distinguish the various types of account. (In general, just over 50 per cent of the total figure may be

attributed to current accounts, approximately 35-40 per cent to deposit accounts and the rest to other accounts.)

(2) *Assets* (generally in descending order of liquidity):

- (a) *Coin, bank notes, balances with the Bank.* This includes actual cash held by the bank at head office and branches and the credit balance held at the Bank of England (which is treated as cash).

National Westminster Bank Limited

Balance Sheet

at 31 December 1977

	1977 £000	1977 £000	1976 £000	1976 £000
Ordinary shareholders' funds:				
Ordinary share capital	224,815		222,067	
Reserves	608,190		561,847	
		833,005		783,914
Preference share capital		13,872		13,872
		846,877		797,786
Loan capital		90,680		97,944
Deferred taxation		85,985		77,293
Amounts due to subsidiary companies		78,403		58,027
Current, deposit and other accounts		9,827,942		8,793,865
Other liabilities:				
Creditors and accrued expenses	20,767		25,136	
Taxation	43,126		22,795	
Dividends	14,554		12,700	
		78,447		60,631
		11,008,334		9,885,546

R Leigh-Pemberton Chairman

Sandon Deputy Chairman
A G Touche Deputy Chairman

W J Benson Director
and Group Chief Executive

F W Hewitt Director
and General Manager,
Financial Control Division

	1977 £000	1977 £000	1976 £000	1976 £000
Liquid assets:				
Coin, bank notes and balances with the Bank of England	383,171		296,920	
Cheques in course of collection on other banks	419,924		409,489	
Money at call and short notice	1,208,904		1,102,476	
Bills discounted	327,037		272,739	
		2,339,036		2,081,624
Special deposits with the Bank of England		175,870		285,960
Certificates of deposit		268,273		260,466
Investments – other than trade investments		562,755		427,674
Customers' and other accounts:				
Advances, less provision	6,399,278		5,703,778	
Other debtors and prepaid expenses	21,984		18,638	
		6,421,262		5,722,416
Trade investments		109,074		105,101
Subsidiary companies:				
Investments—at cost less amounts written off	139,910		134,774	
Amounts owing	441,309		366,879	
		581,219		501,653
Premises and equipment		550,845		500,652
		<u>11,008,334</u>		<u>9,885,546</u>

- (b) *Cheques in course of collection.* This item refers to cheques drawn on other banks which are credited to the account of customers of the National Westminster Bank.
- (c) *Money at call and short notice.* Under this heading is the amount of "surplus money" lent for short periods by the bank to the Money Market (see Chapter 38) at low rates of interest and secured by first-class bills and other securities.
- (d) *Bills discounted.* Under this heading are included: British Government Treasury bills, which carry no risk and earn a little more than money at call and short notice; Other bills, i.e., bills discounted by the bank for its customers.
- (e) *Special deposits.* This item is explained on page 458.
- (f) *Customers' and other accounts.* This item refers to loans and overdrafts made to the bank's customers by way of overdraft on current account and fixed loans.
- (g) *Trade investments.* Under this heading are the bank's principal

trade investments, other than associated companies; they include equity interests of 20 per cent or more with the Agricultural Mortgage Co, Ltd, the Bankers' Clearing House, Ltd, and the Commercial Union Assurance (Unit Trusts) Ltd.

- (h) *Subsidiary companies.* These include County Bank, Ltd, Centre-File Ltd, Coutts & Co, Credit Factoring International Ltd, International Westminster Bank Ltd, NatWest Canada Ltd, Ulster Bank Ltd, Isle of Man Bank Ltd, Handelsbank NE and National Westminster Insurance Services, Ltd.
- (i) *Premises and equipment.* This item tends to be shown in some banks' balance sheets at a figure much below real market value, so that the resulting undervaluation is, in effect, an addition to the reserves of the banks.

THE BANKING ACCOUNT

It is almost impossible to do business of any dimensions today without the convenience of a banking account. As a rule, a business man who contemplates opening an account will find that there are several bank branches near his place of business and, other things being equal, he will choose the bank and branch most conveniently situated for his purposes.

THE ADVANTAGES OF A BANKING ACCOUNT

Although a banker is essentially a borrower of money from the public, the many services he offers in exchange for the loan to him of money on current account are such that, unlike other borrowers, he does not pay interest to the lender. Indeed, unless the average balance maintained by the customer is sufficiently large, it is usual for the banker to charge some form of commission in return for his services.

The following are the chief advantages to the customer of a banking account:

- (1) He is relieved of the risk involved in keeping large sums of money on his premises.
- (2) He is afforded all the facilities offered by the use of cheques as a means of effecting payments.
- (3) He may utilise the services of the banker in the collection of cheques and bills received from his debtors.
- (4) He may obtain advances from the banker by (i) an overdraft or loan against security, or (ii) the discount of bills.
- (5) He can obtain information regarding the stability of persons with whom he transacts business, and may give the banker as a reference as to his own standing.

- (6) He might seek advice from a bank manager on such matters as investments and setting up business.

OPENING THE ACCOUNT

Unless a prospective customer is already well known to the bank manager or to one of the bank's other officials, the customer will invariably be required to provide some form of introduction so that the banker can satisfy himself that the projected account is likely to be conducted in a reasonably satisfactory way and that the facilities afforded by the bank are not likely to be misused.

Furthermore, the prospective customer will be required to supply specimens of his own signature and also specimen signatures of any persons authorised to sign on his behalf—the latter signatures being recorded on a form of “mandate” addressed to the banker.

Bankers will open an account for a public company as soon as it has been incorporated, although they may refuse to release any of the moneys received by them on the account until they have seen the *trading certificate* which gives the company permission to commence business.

TYPES OF ACCOUNT

In all cases the conditions under which the account is to be conducted must be definitely agreed between the bank and its customer. As was mentioned earlier, the account may be either a *current account*, a *deposit account* or a *loan account*. If a *current account* is opened the customer is provided with a *paying-in book* and a *cheque book*, and no interest is allowed on a credit balance on the account, although interest is, of course, claimed by the bank when the account is in debit, *i.e.*, “overdrawn”. The customer is supplied periodically with loose-leaf *bank statements*, recording the debits and credits on his account. The balance is shown after each transaction.

Deposit accounts are opened by customers who have funds available which they do not wish to invest but on which they wish to obtain interest. The transactions between a bank and a customer on a deposit account are recorded for the customer's benefit in a *deposit account pass book* or on loose-leaf statements. The money received on deposit is usually repayable only after the customer has given a specified period of notice (usually seven days) of his intention to withdraw the funds.

THE PAYING-IN BOOK

The object of this book is to provide the customer with an acknowledgement by the bank of moneys paid in to the credit of his account.

Cash, cheques, bills, coupons and other documents representing money are entered up in the book, with a note of the date on which they are paid in. The book is then taken along to the bank and tendered, with the cash and other documents, to the cashier, who checks the entries, retains the articles paid in and the tear-off slip bearing the list of items, and returns the book, after having impressed the bank stamp on the counterfoil.

Cash and cheques are credited immediately to the account and bills, foreign cheques and similar items are collected by the bank on behalf of its customer and credited as the proceeds are received.

RECONCILING THE BANK BALANCE WITH THE CASH BOOK BALANCE

In reconciling the statement with the cash book a certain amount of difficulty may be experienced owing to the fact that the book may contain a record of certain payments-in that have not yet been "cleared", *i.e.*, the proceeds of which are not yet available, and of certain drawings (by cheque) which have not yet been paid out by the bank (the cheques not yet having been presented for payment). In order to check the accuracy of both cash book and statement in these circumstances, it is necessary to prepare what is known as a *reconciliation statement*.

Suppose, for instance, that on a certain date a firm has a credit balance, according to its statement, of £3,972·15, but that according to its cash book its balance should be £4,075·80. To check the accuracy of these figures a statement is made out on the lines of that on page 470.

In the majority of cases, of course, the statement will be more complicated than that shown, which is only an illustration. The amounts to be *added*, as illustrated below are ascertained from the cash book and statement by ticking off the items credited on the latter against those credited in the former, the unticked items representing those not yet cleared or credited by the bank to the customer at the time the latest pass sheet was issued. The amounts to be *subtracted* are obtained by ticking off the debit entries in the cash book with those on the pass sheet when the unticked entries in the former represent cheques not yet paid by the bank up to the time the latest pass sheet was issued. If debit items such as bank charges appear on the bank statement that have not yet been entered in the books of the business, they will be added to the credit balance.

BANK RECONCILIATION STATEMENT

30th April, 19..

	£	
Credit Balance as per Bank Statement	3972·15	
Add Amounts paid in but not credited:—		
28/4/...	£117·60	
29/4/...	75·50	
	<hr/>	193·10
Add Bank Charges debited 15/4/...		10·50
		<hr/>
		4175·75
Less Cheques drawn but not presented:		
No 321374	£51·35	
321377	48·60	
	<hr/>	99·95
		<hr/>
Credit Balance per Cash Book	£4075·80	
	<hr/>	

THE RELATION BETWEEN BANKER AND CUSTOMER

When a customer deposits money with a bank, the money becomes the bank's property at its absolute disposal. In other words, the banker does not become the customer's agent or trustee; he may invest or lend the money as he thinks fit and he is not responsible to his customer for any profit made on this money. *The basic relationship between banker and customer is that of debtor and creditor*: normally the banker is the debtor and the customer the creditor; but where the latter's account is in debit the positions are reversed.

Nevertheless, the relationship between banker and customer differs from the normal relationship of debtor and creditor in that there are certain superadded obligations on each party arising out of an implied contract between them. These special features of the relationship are as follows:

- (1) THE MONEY OWING BY THE BANKER IS NOT REPAYABLE UNTIL A DEMAND FOR REPAYMENT HAS BEEN MADE BY THE CUSTOMER.
- (2) THE BANKER'S DUTY TO HONOUR CHEQUES. It is a part of the implied contract between banker and customer that the banker will honour his customer's cheques to the extent of the latter's credit balance or to an agreed overdraft limit, provided that the cheques are in order (*i.e.*, correctly drawn), that the customer has not countermanded payment, and that there is no legal bar prohibiting payment.
- (3) THE BANKER'S DUTY OF SECRECY. A banker may not disclose any

details concerning his customer's account or any information regarding his customer that he may have obtained from other sources, except in the following circumstances:

- (a) *Where there is compulsion of law*, as for example, where the banker is compelled to give evidence before a Court.
 - (b) *Where there is a duty to the public to disclose*, as where disclosure is necessary to avert a danger to the State.
 - (c) *Where the bank's interest require disclosure*, as where the amount of an overdraft is stated in a writ.
 - (d) *Where the customer has given his express or implied consent to the disclosure* (see below under *Bankers' Opinions*).
- (4) **THE BANKER'S LIEN.** The banker has a general lien on any securities of a customer which come into his hands in the ordinary course of business for any purpose not inconsistent with lien. Banker's lien differs from ordinary lien in that it gives the banker the right not only to *retain* but also to *realise* the securities to which it applies.
- (5) **A BANKER HAS A RIGHT TO CHARGE REASONABLE COMMISSION AND INTEREST** on the customer's turnover or balance.

BANKERS' OPINIONS

One of the most important services rendered by bankers is that of acting as *referees* as to the standing of their customers. Whenever a trader feels any doubt as to the reliability or solvency of a prospective client, information may be obtained from the former's banker, who will be able, through the machinery of his "information" or "Intelligence" Department, to supply reliable and up-to-date information with a minimum of delay. The obtaining of such information is facilitated if the name of the client's banker is known, as the banker may then put through an inquiry direct.

From the banker's point of view the answering of such inquiries is a delicate matter involving great care. Despite the banker's duty to preserve secrecy concerning his customer's affairs, it is possible that the practice among bankers of exchanging general information concerning customers is so well established that a customer, in the absence of an express stipulation to the contrary, would be deemed to have impliedly consented to the giving of such opinions. Nevertheless, the banker must always take care not to include in his opinion any statement that might amount to unjustifiable disclosure of his customer's affairs. In no case should he give any such information except to one of his own customers or to another bank; and even then he should not disclose the actual balance on the customer's account.

ENTRIES ON A CUSTOMER'S BANK STATEMENT

Entries on a customer's statement are *prima facie* deemed to be correct, but either the banker or the customer may call evidence to show that they are in fact incorrect in which case they may be adjusted, provided the customer is not injured by the adjustment. If, however, a customer whose statement incorrectly shows too large a credit balance is led in good faith and in reliance upon the position shown by it to draw in excess of his true credit balance, such customer may succeed against the banker for damages if cheques are in consequence dishonoured by non-payment.

But a customer is under no obligation to examine his pass book or statement, nor, having examined it, does he in any way warrant the accuracy of the entries therein. Thus, if at any time he discovers that cheques have been wrongly debited to his account or that he has not been credited with amounts due to him, he can demand that his balance be restored, even if his silence has prejudiced the banker's position, providing his silence had no fraudulent intent.

CLOSING AN ACCOUNT

Although a customer may at any time close a current account with a banker by withdrawing his credit balance, or, if the account is overdrawn, by paying off the debit balance plus any accrued interest or charges, the banker, however unsatisfactory a customer's account may be, cannot close it without due notice. The necessary period of notice will depend entirely upon the circumstances of each case, but it must be sufficient to enable the customer to complete any outstanding transactions. In one case as much as one month's notice was held to be insufficient.

On the closing of an account it is usual for the banker to ask the customer to certify that the account is settled.

MISCELLANEOUS SERVICES RENDERED BY BANKERS

ADVISING UPON INVESTMENTS

Customers frequently approach their bankers for advice concerning the disposal of funds that they are anxious to invest. The course usually adopted by the banker is to obtain from his brokers a selected list of investments suitable for the customer and to forward this to the customer stating that it is the broker's and not his own opinion.

STANDING ORDERS

A *standing order* is an authority or mandate in writing addressed to a bank by a customer, signed by the latter, instructing the bank to pay

a subscribed sum (*e.g.*, an insurance premium or club subscription) to a named person periodically on specified dates and to debit the amounts to the customer's account.

SAFE CUSTODY

Customers frequently take advantage of the security offered by their banker's vaults to deposit with him valuable documents, securities, jewellery and similar objects of value, all of which the bank places under lock and key and releases only at the request of the customer or, in the event of his death, to his personal representative.

CAPITAL ISSUES

When a company issues capital, or makes a call on existing shareholders, it is usual to call in the services of its bankers to accept and give receipts for the payments, and to act as a depository of the funds. In the case of a new issue the bank's name is usually shown on the prospectus, though the consent of the bank must be obtained before this is done, and, to this end, the bank should be sent a draft copy of the prospectus for inspection and approval.

Before the prospectus is sent out, arrangements are made for a special banking account to be opened (or for more than one where there is more than one class of shares), and for all application moneys to be credited to this account. The application forms are numbered in rotation and are entered by the bank as received on special statements, which are sent to the company with the application forms for checking and further action.

When money is payable on allotment or when a call is made, the bank will open an Allotment Moneys Account or a Call Moneys Account and follow a similar procedure.

PAYMENT OF DIVIDENDS

Another instance in which a banker is of use to a company arises when dividends have to be paid. Then the secretary will arrange to open a special dividend account with the bank by a transfer from current account to cover the total amount for which warrants are issued, and the banker will be instructed to debit all paid warrants to this account.

Banks are also of use to companies in the transmission of dividends and interest to the accounts of the bank's own customers who are share- or debenture-holders and have signed the necessary mandate in favour of their bank for this to be done.

FINANCING TRADING OPERATIONS

The main function of a banker, apart from those already discussed, is to assist in the finance of trading operations. This, however, is of sufficient importance to warrant separate treatment and is discussed in detail in Chapter 37.

CHEQUE CARDS

These cards increase the acceptability of cheques by adding the credit of the bank to that of the drawer of the cheque; they make cheques as good as cash. They are issued free to customers and may generally be used for payments not exceeding a limited sum. A cheque within this amount made out by the holder of a card will be honoured by any branch of the bank on which it is drawn or of any bank with which reciprocal arrangements have been made. Thus suppliers of goods and services are assured of payment if they accept cheques accompanied by cheque cards from unknown customers. The commercial banks using this service other than Barclays issue a standardised form of cheque card.

THE NATIONAL SAVINGS BANK

The National Savings Bank is the renamed Post Office Savings Bank which, in 1969, was transferred to the Department for National Savings. Two series of Savings Bank accounts are currently available: ordinary accounts, paying interest; investment accounts, offering higher rates of interest.

ORDINARY ACCOUNTS

Savings Bank Ordinary Accounts may be opened with 25p minimum) at any of 20,000 savings bank post offices in the U.K. A bank book is issued in which transactions are recorded. The State guarantees repayment of deposits with interest.

Types of ordinary accounts which may be opened include the following: individual accounts; joint accounts; trust accounts, opened by persons in trust for others named in the account; trustee accounts, available to trustees under legally constituted trusts; direct transfer (DX) accounts, related to schemes by which employers make regular deductions from employees' pay for direct credit to such accounts.

No amount may be accepted from a depositor or joint depositors which brings the aggregate amount standing to credit on ordinary account to more than £10,000 plus current interest. Deposits may be withdrawn on demand up to £50 from any savings bank post office.

Other facilities for withdrawal include: warrant payable at a specified post office; crossed warrant; telegraph withdrawal; postal application for payment by telegraph. Depositors may give standing instructions for regular payments of fixed amounts for insurance, subscriptions, etc. Money deposited in the National Savings Bank is paid over to the National Debt Commissioners and is invested in securities guaranteed, or issued, by the U.K. Government.

INVESTMENT ACCOUNTS

Investment Accounts may be opened with £1 or more at any savings bank post office, except in the case of a legal trust or society, when application must be made to the Bank's Director.

Withdrawals are subject to one month's written notice accompanied by the Investment Account Bank book. Payments on demand are not permitted. Facilities for withdrawal include: by warrant at a specified post office; by crossed warrant. In general, money deposited bears interest from the beginning of the month following that in which it was received; money withdrawn will cease bearing interest from the beginning of the month in which withdrawal was made.

CHAPTER THIRTY-SEVEN

Banks and the Finance of Trade and Industry

Since their original function of safeguarding the money and valuables of merchants, banks have come to perform for their customers numerous other services, mainly in connection with the settlement and financing of business transactions. These services may be separated into two broad categories:

- (a) The provision of machinery for *making payments*.
- (b) The provision of *credit* for traders and others.

BANKS AND THE SETTLEMENT OF INDEBTEDNESS

As has been indicated in the description of the work performed by the Clearing Houses, the cheque and credit systems enable debts throughout the country to be set off one against the other without any large, actual transfers of actual money from place to place. A similar system prevails for the settlement of international indebtedness.

A debt between two traders may be settled either by the creditor drawing a bill on his debtor and selling it, or by the debtor sending his creditor a remittance such as a cheque or bank draft. Where the first method is adopted the creditor uses the services of his bank to obtain payment of the bill. He gets his banker to buy (*i.e.*, discount) the bill or to collect its amount for him. Where the second method is adopted, the debtor either draws a cheque on his bank or buys a draft from his bank for the amount he wishes to pay.

DISCOUNTING OF BILLS

Banks are willing to discount bills payable at a future date, provided that they are satisfied as to the standing of the parties to each bill.

The procedure of discounting bills thus provides a means for reconciling the claims of debtors and creditors. The debtor may obtain credit by accepting a bill payable in, perhaps, three months' time instead of having to pay at once for goods he has bought; on his part the creditor can discount or negotiate the bill at once and so obtain immediate payment for goods he has sold.

The terms "negotiating" and "discounting" a bill are usually interchangeable, but the former term is used specially in connection with foreign bills and also to refer to the purchase by a bank of sight

drafts, etc., in foreign currency where the term "discount" would not be applicable.

COLLECTION OF BILLS

Where the standing of the parties is not sufficiently good to allow a bill to be discounted, or where the drawer is unwilling to bear the cost of discounting it, the usual procedure is to hand the bill to a banker for collection. When this is done, the banker forwards the bill to his agent in the place where the drawee resides, and requests him to present the bill for acceptance and payment. When the bill is paid, the agent credits the banker's account in his own books, and the collecting banker, on receipt of advice of payment, pays over the amount of the bill, less a small commission, to his customer the drawer.

SALES OF FOREIGN REMITTANCES BY BANKERS

By collecting for its customers bills payable abroad, and also by collecting on its own account foreign bills that it has negotiated, a bank's balances *in foreign centres* are *increased* while its funds *at home* are *depleted*. The bank adjusts this position and at the same time realises a profit by the sale of various forms of remittance to debtors who have to remit to their creditors in other countries.

THE PROVISION OF CREDIT

Other than in the retail trade only a small proportion of daily transactions in the modern commercial machine is carried through on a cash basis. The great majority are conducted on credit—based on the belief by one man in the probity and solvency of another—and it is one of the most important functions of the banks to act as intermediaries to encourage the giving and taking of credit *so that commercial transactions may proceed with as little delay and uncertainty as possible*.

The type of credit required by a business concern from time to time may fall into one of three classes:

SHORT-TERM CREDIT. This is required for temporary use, to finance the purchase of stock, to finance sales at the height of the season, or to pay for capital improvements whilst a long-term loan is being arranged.

INTERMEDIATE CREDIT. This is credit advanced (a) for short periods which is required in the case of hire purchase sales, where the ownership of goods is retained by the seller until payment is completed; (b)

for advances against deferred payment, in which the ownership of goods passes to the buyer and payment is spread over a period; and (c) for long period contracts for, *e.g.*, public works.

LONG-TERM CREDIT provides finance for permanent capital assets in the form of buildings, plant and machinery.

In Britain long-term capital is usually obtained by issues on the London Capital Market or through such concerns as Finance for Industry Ltd, and the Agricultural Mortgage Corporation Ltd. Intermediate credit for hire purchase sales and deferred payment sales is provided by specialist organisations such as the United Dominions Trust Ltd.

Some intermediate credit, and also the great bulk of short-term credit, are provided by the commercial banks, and this may be done (a) by the actual granting of advances, or (b) by the issue of letters of credit. Finance for Industry Ltd also supplies intermediate and short-term credit.

TYPES OF BANK LOANS

Before making a loan a banker requires to be satisfied on the following points:

- (1) The purpose of the loan must be satisfactory (*i.e.*, not speculative and preferably productive). Is it, in fact, a banking proposition?
- (2) There must be a definite arrangement for repayment, and the borrower must show from what source he intends to obtain the necessary funds to make repayment.
- (3) The borrower's financial position, as shown by his balance sheet or other financial statement, profit and loss account, etc., must be satisfactory. Are his integrity and reliability beyond question?

Banks advance money to customers in the form either of a fluctuating overdraft on current account or of a fixed advance on loan account, or by discounting bills of exchange or promissory notes.

OVERDRAFT. By this method the customer is authorised to draw cheques on his current account up to a fixed limit, and interest is charged only on the daily balance. The customer obtains the advantage of reducing his debt, if only temporarily, whenever he has funds in his hands which can be paid in, but the rate of interest charged is usually higher than that charged on a fixed loan, while a commission on the turnover is often exacted which adds considerably to the cost of the borrowing.

LOAN ACCOUNT. By this method a definite sum is advanced by debiting the advance to a "loan account" and crediting the customer's current account. Interest is charged at a slightly lower rate than that charged on a fluctuating overdraft, and it is a matter of agreement as to whether or not commission is charged on the current account turnover. This method of borrowing is especially useful where the applicant's borrowing powers are limited, as in the case of building societies and some registered companies.

From many aspects, borrowing on overdraft from a bank offers an ideal form of temporary accommodation to a trader. If an advance in any other form is taken, the trader will usually have to maintain the loan until the whole amount is repaid, pending which he will have to pay interest on the full amount or on the reducing balance where a loan is repayable by regular transfers from current account at monthly or other infrequent intervals. In the case of an overdraft he pays interest daily only to the extent to which he has actually utilised the agreed loan, while any remittances he receives in the course of his business will automatically reduce his indebtedness. In many cases, advances are required by traders to finance the sale of goods on credit; and in such circumstances an overdraft is especially useful, for the advance can be repaid piece-meal as payment for the goods is received.

The discounting of bills from the banker's point of view is a profitable method of financing trade and commerce. The bill is automatically repaid at maturity; or, if not, the banker has a right of recourse against both the drawer and the acceptor, instead of merely against his customer as in the case of an overdraft. Moreover, the period which a bill has to run before payment is fixed by the bill itself, whereas advances in the form of loans or overdrafts have a tendency to remain outstanding for a longer period than was originally intended.

SECURITIES FOR ADVANCES

A banker will seldom grant a customer an advance except against security of reasonably stable value, and with a good margin to allow for contingencies. Since the security is required by the banker to safeguard himself against the loss of his money, and to ensure prompt repayment of his advances, the security must be such that he can rely upon realising it without difficulty or loss. The essentials of a good banking security are, therefore:

- (1) It must be readily valued and easily realised.
- (2) Its value must be stable.

- (3) The banker's title must be easily established and free from risks of dispute.
- (4) There must be no liability attaching to the security.
- (5) The security must not entail heavy expense or onerous formalities.
- (6) The estimated realisable value should yield an ample margin over the amount of the advance.

The following are the principal types of security taken for this purpose:

STOCKS AND SHARES. These are generally a satisfactory form of security as they can be made available as cover without great expense, and are readily realisable in case of need. The banker, however, regards every security on its merits and the customer will find it easier to obtain an advance against gilt-edged securities or first-class debentures than against mining shares. In no case will the banker grant an advance above about 80 per cent of the current value of the securities and, in the case of shares of relatively less stable value, he will insist on a wider margin.

Bearer securities afford perhaps an ideal cover from the point of view of both banker and customer, since they can be made available as security by deposit with the banker. *Registered securities* can be made effective as security only by transfer and registration in the names of the bank's nominees. *Quoted securities*, i.e., stocks and shares quoted on a stock exchange, are more acceptable than *unquoted securities* because they are more easily realisable and their value can be more readily ascertained.

GUARANTEES. If the customer is not prepared to deposit any other form of security acceptable to the banker, an advance may be arranged against the security of a guarantee given by a third person of adequate standing. A guarantee is defined as "a written promise made by one person to be collectively answerable for the debt, default, or miscarriage of another": *Statute of Frauds* 1677, s. 4. Such a guarantee must be in writing, signed by the guarantor, and must embody an undertaking by the guarantor to be responsible to the banker should the customer (the principal debtor) default. Guarantees are commonly taken to secure advances made to minors or to other persons of limited contractual capacity, but it is then necessary to require the guarantor to assume primary liability by means of an *indemnity clause*, while in some cases a banker will ask for a guarantee on the part of the directors before advancing money to a limited company, the object being to secure the unlimited liability of the directors. The value of a guarantee as security is, of course, dependent entirely upon the financial worth of the guarantor.

LAND is generally an excellent form of banking security, but bankers usually, though not exclusively, grant advances against mortgages for short periods only: where a long-term advance is required the matter is best arranged through a solicitor or building society. Where the advance is required for a very short period only, it may be sufficient for the customer merely to deposit the title deeds to the property with the banker, together with a *memorandum of deposit* stating the purpose for which they are deposited. This procedure gives the banker merely an *equitable mortgage* over the property; and, although the customer is prevented from dealing further with the property without the knowledge of the banker, the latter acquires no right to realise the property except with the permission of the court. When, however, the banker decides to grant a loan against the security of land or buildings he will usually prefer to take a *legal mortgage*, by which he obtains the legal ownership of the property and so is fully protected.

DOCUMENTS OF TITLE TO GOODS are frequently taken as security in respect of a loan. They are not, however, the best type of cover, as the value of most goods is subject to wide fluctuations, and of some to rapid deterioration, while there is much scope for mis-statements as to that value in the documents. Where documents of title, *e.g.*, dock or warehouse warrants, are accepted as security, the customer may hand them to the banker together with a *letter of hypothecation* acknowledging the banker's property in the goods and his right to dispose of them upon default in repayment of the money lent.

LIFE POLICIES. Although these are most useful as collateral security to avoid realisation of other securities in the event of the death of the borrower, they are frequently accepted as primary security for an advance. In either case, however, unless the advance is for a short term, a banker may protect himself by taking a *legal assignment* of the policy, while he will not in any case advance an amount exceeding the current surrender value of the policy. This is perhaps the most acceptable form of security.

Apart from the types of security described above, advances to joint stock companies are commonly secured by debentures conveying a fixed and/or floating charge over some or all of the company's assets.

COLLATERAL SECURITY

All the above types of security are frequently spoken of as *collateral* or additional security, since they afford the banker a right of action collateral to, or running side by side with, the banker's right of action against the customer *personally* in respect of any loan or overdraft.

There are, however, two other senses in which the term is commonly used:

- (a) To describe any of two or more instruments which *secure the same debt*, as, for example, where a loan is covered by the pledge of share certificates and also by the assignment of a life policy.
- (b) To describe security which is given *by a third person or persons* to ensure a customer's repayment of a loan, e.g., a guarantee signed by *A* as guarantor of an overdraft granted by a bank to its customer *B*.

LENDING POLICY OF BRITISH BANKS

Apart from the important question of adequate and easily realisable security, the chief point that a banker in this country has to bear in mind when considering an application for an advance is the question of *liquidity*. British banks supply only *short- or medium-term* capital and will not, other than in exceptional circumstances, entertain any application for an advance required for long-period capital works such as buildings or the purchase of land. The main reason for this, of course, is that the bulk of the disposable funds of British banks is obtained from the deposits of their customers, and, as these deposits are liable to be withdrawn at short notice by cheque or otherwise, the assets held by the banks against them must be easily realisable and not tied up for long periods. Accordingly, before granting any advance, a banker will require to be satisfied that the customer proposes to use the money as liquid capital in his business, and that the loan is likely to be steadily reduced and repaid within a comparatively short period. As a result of the banks' policy in this respect,

CLASSIFICATION OF BANKERS' ADVANCES TO U.K. RESIDENTS, NOVEMBER 1977

	£m	%
MANUFACTURING		
Food, Drink & Tobacco	1,805	4.7
Chemicals	1,592	4.2
Metal Manufacture	499	1.3
Electrical Engineering	667	1.7
Other Engineering	1,541	4.0
Shipbuilding	512	1.3
Vehicles	510	1.3
Textiles and Leather	724	1.9
Other Manufacturing	1,529	4.0
Total Manufacturing	9,380	24.6

OTHER PRODUCTION

Agriculture, Forestry and Fishing	1,514	4.0
Mining and Quarrying	1,393	3.7
Construction	1,583	4.2
Total Other Production	4,491	11.8

FINANCIAL

Hire Purchase	627	1.6
Property	2,505	6.6
Other Financial	3,834	10.1
Total Financial	6,967	18.3

PERSONAL

House Purchase	1,470	3.9
Other Personal	3,318	8.7
Total Personal	4,788	12.6

SERVICES

Transport and Communications	1,589	4.2
Public Utilities	3,292	8.6
Local Government	702	1.8
Retail Distribution	1,517	4.0
Other Distribution	2,429	6.4
Professional, Scientific and Other	2,977	7.8
Total Services	12,505	32.8
Total Advances	38,131	100.0
of which:		
in sterling	27,020	70.9
in foreign currency	11,111	29.1

(Note: Figures may not always sum exactly to subtotals due to rounding.)

Source: Barclays Review and Bank of England

British traders and industrialists cannot generally rely upon the banks to supply them with permanent capital.

The chart above shows a classification of bankers' advances in November, 1977.

THE MACMILLAN COMMITTEE ON FINANCE AND INDUSTRY

The complaints of industrialists that their requirements were not being adequately met led the Government to set up in November, 1929, a Committee of economists and business men under the chairmanship of Lord Macmillan, "to inquire into banking, finance and credit . . . and to make recommendations calculated to enable these agencies to promote the development of trade and commerce and the employment of labour".

The Committee came to the conclusion in its Report in 1931, that, although British manufacturers and traders had always been able to find cheap accommodation, yet, largely for historical reasons, the relations between British banks and industry had never been as close as those between banks and industry in the United States and on the Continent. It emphasised the need for closer association, through appropriate organisations, of the financial and industrial worlds and recommended that specialised institutions should be set up to perform the following functions:

- (a) To act as financial advisers to existing companies, particularly in regard to the provision of permanent capital.
- (b) To secure the underwriting and issuing of companies' securities to the public and, if necessary, to assist previously in arranging for temporary finance in anticipation of an issue.
- (c) To assist in financing long-term contracts at home and abroad, or new developments of an existing company, or founding companies for new enterprises.
- (d) To act as intermediaries and financial advisers in the case of mergers or in the case of negotiations with corresponding international groups.
- (e) To be free to carry out all types of financing business.

Such institutions should be independent, though their capital could be subscribed by the leading private institutions and the big banks. One such institution would supply finance for large-scale organisations, and for the small and medium-sized concerns, another type of financial institution which would confine itself to smaller industrial and commercial issues of long-term capital would be desirable.

The so-called "Macmillan Gap" (*i.e.*, the absence of long-term facilities for industry) continued unbridged until 1945, when two Government-sponsored institutions were formed to provide long-term and medium-term financial resources for industrial development. These were: Finance Corporation for Industry Ltd and Industrial and Commercial Finance Corporation Ltd. The two institutions were merged in 1973 as FINANCE FOR INDUSTRY LTD.

Further help was made available for industry by the I.C.F.C. in 1953 when it established a subsidiary, the *Estate Duties Investment Trust, Ltd.*

In 1947 there was a further development when Barclays Banks (Dominion, Colonial and Overseas) Ltd, and the Standard Bank of South Africa Ltd, as they then were, each formed a subsidiary undertaking to provide medium-term finance for concerns wishing to develop commercial enterprises in the territories in which the parent banks operate.

AGRICULTURAL CREDIT

In addition to the measures taken to assist industry generally, steps were also taken to improve the position of agriculture in Britain. After consultation with the banks and other interests, the *Agricultural Credits Act* 1928, was passed, which dealt with the provision of short-term and long-term credit.

SHORT-TERM CREDIT. The Act provided for the creation of a new form of charge, known as an *agricultural charge*, which could be given in favour of a bank in the form of a floating charge over the agricultural assets owned by a farmer.

LONG-TERM CREDIT. A new company, known as the *Agricultural Mortgage Corporation Ltd*, was set up for the provision of long-term credit to farmers. The capital was subscribed by a number of the large banks, and loans are granted by the Corporation (a) against mortgages of agricultural land; and (b) in respect of major improvements to agricultural land and buildings.

Borrowers from the Corporation are required to meet fixed interest and capital repayments at half-yearly intervals, so that the scheme applies to the acquisition of land the same principles as building societies have so successfully applied to the acquisition of homes.

LETTERS OF CREDIT

The object of a letter of credit is to substitute the credit of a well-known bank for that of a comparatively unknown trader, and so to facilitate trade where otherwise it would have been all but impossible. Generally, a letter of credit consists of an *undertaking by a banker* that bills drawn on the banker in compliance with the terms of the credit will be duly honoured.

One of the most commonly used forms of credit is one opened at the request of an importer by a banker either in the importer's country, or in the exporter's country, under which the issuing banker

undertakes that bills drawn by the exporter will be duly honoured, provided they comply with the terms of the credit. The exporter is thus able, on the strength of the issuing bank's undertaking, to negotiate bills drawn under the credit with ease and at a "fine" rate of discount.

CONFIRMED CREDITS

A CONFIRMED (OR IRREVOCABLE) CREDIT is one in which the issuing banker gives a definite undertaking to accept and, in due course, to pay bills drawn upon him in compliance with the terms of the credit. This is the definition usually accepted, but in some quarters a credit is not regarded as *confirmed* unless the banker through whom the credit is advised to the beneficiary adds his confirmation to that of the issuing banker.

UNCONFIRMED CREDITS In an unconfirmed (or *revocable*) credit, the issuing banker gives no such undertaking, but merely intimates that he is prepared to honour drafts drawn under the credit unless, in the meantime, the credit is cancelled. The value of an unconfirmed credit is considerably enhanced if, as is often the case, the issuing banker *undertakes* to honour drafts negotiated prior to the receipt by the negotiating banker of notice of cancellation.

ACCEPTANCE CREDITS Strictly, this term refers merely to a credit which provides for bills to be drawn requiring acceptances, as distinct from *sight credits*, which call for the drawing of sight drafts. The term is, however, more usually applied to credits which provide for bills to be accepted *by a bank*, as distinct from credits such as *authorities to negotiate* which provide the bills to be drawn direct on the importer. In this sense the term is usually qualified by the name of the town in which the bills are to be accepted, *e.g.*, Paris acceptance credit, New York acceptance credit. The term "London Acceptance Credit" is often used in a special sense to refer to a credit opened with a London bank or accepting house at the request of an English *exporter*. This arrangement enables an exporter, merely by drawing on his own bank, to obtain, in payment for goods exported, a London bank bill discountable at very fine rates, instead of a foreign trade bill discountable at higher rates or possibly not discountable at all.

DOCUMENTARY CREDITS. A documentary credit is one that provides for bills to be accompanied by specified shipping documents, as distinct from a *clean credit*, where no documents need accompany the bills.

OMNIBUS CREDITS are those granted to shippers of high standing to enable them to draw round amounts on a bank against the security of a general lien on their goods.

FIXED CREDITS are those available for a fixed total amount, either in one draft or in several.

REVOLVING CREDITS are those which are automatically renewed from time to time as certain conditions are fulfilled. They are of four types: (a) for a fixed amount in one draft at any one time, the credit being immediately re-available; (b) for a fixed amount in one draft at any one time, the credit not being re-available until advice has been received of payment of the previous draft; (c) for an unlimited amount in all, but with a limit to the total of drafts outstanding at any time; (d) for a limited amount during a specified period.

TRANSFERABLE CREDITS. Fixed credits which authorise the beneficiary to transfer his right to draw against them to a new beneficiary of his choice. It is the custom of British banks to limit this authority so that transfer can occur once only. A *transferable and divisible credit* enables the first beneficiary to transfer drawing rights against parts of the total amount of the credit to two or more beneficiaries.

The descriptions given above are merely characteristics of various types of credit and are not in themselves complete and distinct forms. For example, a traveller's letter of credit (see below) has the characteristics of being confirmed, fixed and clean, while many confirmed credits are also documentary and fixed credits.

THE USE OF LETTERS OF CREDIT IN FOREIGN TRADE

The following typical example will serve to illustrate the manner in which foreign trade may be financed by the issue of letters of credit.

It may be assumed that an exporter in Ceylon has arranged to ship tea to an importer in U.S.A., and, not being satisfied as to the standing of the importer, has requested that payment be made by sterling drafts at sixty days' sight on a London bank. In such circumstances, the American importer will instruct his own bankers in, perhaps, Washington, to open a confirmed documentary credit with their London agents in favour of the Ceylon exporter. The instructions to the London bank will specify the amount of the credit, the period for which it is to remain open, the documents that must be attached to each bill, and other details, and will contain an authority to the London bank to debit all drafts accepted by it to the account of the American bank. Upon opening the credit, the London bank will advise the exporter's bankers of the terms under which it is prepared to accept drafts; and on the strength of this undertaking the exporter will readily be able to discount any drafts drawn by him in respect of the shipments of goods, even before the drafts are accepted.

It will thus be seen that a letter of credit, by enabling the exporter

to draw on a bank of international repute, instead of on a comparatively unknown importer, enables him to turn his bill into cash at a satisfactory rate of discount as soon as the goods are shipped; while, on the other hand, the importer is enabled to purchase goods from an exporter who might otherwise require payment at the time the order was given. The letter of credit bridges the "credit gulf" between two people who would otherwise have no means of ensuring that the other would carry out the engagements entered into, while at the same time it gives rise to a bill of exchange bearing the signature of a well-known bank.

NON-COMMERCIAL CREDITS

The various credits described above are what are known as *commercial* credits, since their object is to assist international trade. There are other types of credit, the object of which is to enable travellers in foreign countries to avoid the risk of carrying large sums of money about with them.

TRAVELLERS' LETTERS OF CREDIT. A traveller's letter of credit consists of a request by the issuing bank to its agents and correspondents abroad to cash on demand any drafts drawn by the holder on the issuing bank up to a stipulated amount during a specified period. Travellers' L/C's take three forms:

- (a) *Circular or World-Wide Letters of Credit*, which are available with any of the bank's agents and correspondents.
- (b) *Limited Letters of Credit*, which are addressed only to certain of the bank's agents and correspondents.
- (c) *Travellers' Commercial Letters of Credit*, which are issued to enable the holder to purchase goods at various points. As a rule, drafts drawn under this type of credit must be accompanied by specified shipping documents.

In order that the agents and correspondents of the issuing bank may be able to identify the traveller, he is furnished with a *letter of indication*, containing his specimen signature, which he must produce when he desires to cash a draft.

TRAVELLERS' CHEQUES. These are drafts drawn by the holder on the issuing bank for round sums in sterling, and encashable by the bank's agents and correspondents abroad at the current rate of exchange. The holder signs the cheques in the presence of the issuing bank, and is required to endorse them when they are cashed. The cashing banker is thus enabled to compare the two signatures.

CIRCULAR NOTES. These documents are similar to travellers' cheques, but bear on the front a request to the bank's agents and correspondents to hand the holder cash for the stipulated amount. On the back is a form of cheque to be drawn by the holder on the issuing bank.

CIRCULAR CHEQUES. These are issued by banks to their agents and correspondents abroad, for sale by the latter to customers visiting the country of the issuing bank. They resemble cheques in form, and are drawn on the issuing bank by its correspondents, who, when selling these cheques, fill them in for the amount required by the customer.

In the case of the non-commercial credits enumerated above, it is necessary to comply with any exchange-control regulations governing the amount of money a traveller is permitted to take out of the United Kingdom.

CREDIT CARDS

These differ from cheque cards (see page 474). A cheque card guarantees payment of a cheque whereas a credit card guarantees payment against a sales voucher signed by the cardholder. Each credit card has a specimen signature of the holder and is embossed by the issuing bank with the holder's name and number. The cardholder gives his card to one who supplies him with goods and services, the supplier having agreed to join the scheme. The card is placed in an imprinter machine which records the holder's name and number on a sales voucher bearing particulars of the transaction. The holder signs the voucher and his signature is compared with that on the card. At the end of the month the cardholder must remit his cheque for the full amount involved. Some 6 million cards were in use in 1978-9 in Britain.

Credit cards obviate the need to carry large amounts of cash in case suppliers refuse to accept their cheques and also the holder enjoys a period of free credit. There is the danger that holders might overspend and some object to the paper work involved. Cheque cards where payment is guaranteed by a bank are then preferred.

It should be noted that it is now common practice for some banks not to issue cheque cards or credit cards until it has been established that the new customer is a person of responsibility and integrity and that he is ready to provide the bank with security beyond the total risk involved.

CHAPTER THIRTY-EIGHT

The London Money Market

The London Money Market comprises the numerous banks, brokers, discount houses and merchant banks in the City of London, who trade in money and credit. The Money Market is really a "market within a market" for it is a part of the English Capital Market which includes the whole of the specialised and centralised machinery for facilitating the transfer of capital from those who wish to invest to those who wish to borrow. The Money Market proper is concerned mainly with *short and medium term borrowing and lending*.

MEMBERS OF THE MONEY MARKET

The Bank of England is the pivot of the Money Market and as the central bank it can exert a great influence on the monetary conditions ruling on the market and in the country generally. It is "a lender of last resort", always ready to lend to the market at a price, and is thus a stand-by in case of emergency. (The functions of the Bank are outlined in Chapter 35.)

THE PRINCIPAL LENDERS are the clearing banks. The funds they lend are the balance of the deposits made with them by their customers that remains after adequate provision has been made for meeting demands for cash and for loans, investments, etc. The banks lend for short periods, frequently overnight, at low rates of interest. Other lenders are Commonwealth and foreign banks and finance houses.

THE PRINCIPAL BORROWERS. In the public sector of the economy, the Government borrows heavily against Treasury Bills to meet current expenditure, in anticipation of tax revenues, or to finance budget deficits, and local authorities and public corporations borrow to finance current spending, pending receipts from rates and from the sale of goods and services.

In the private sector industrial and commercial firms borrow from the market for the temporary financing of their businesses. The main borrowers are bill brokers, discount houses (who use the borrowed funds to discount bills), accepting houses and stock exchange brokers and operators (who employ the funds for facilitating dealings in securities).

TREASURY BILLS

The issue of Treasury Bills is carried out by the Bank of England on behalf of the Treasury, and provides the Government with a useful method of borrowing for short periods. Treasury Bills are also available "on tap", that is, Government Departments take as many as they like at a nominal rate. The Bills are payable in ninety-one days or sometimes in sixty-three days and are available for weekly tender to the discount market, which makes a syndicated offer for the amount offered for tender. The offer price is lower than the maturity price and the difference between the two prices is the ruling rate of interest at which the market is prepared to make short-term loans to the Government; it is known as the *Treasury Bill rate*.

THE DISCOUNT MARKET

This Market comprises those firms which form the *London Discount Market Association*, a few smaller firms, money traders and the "eligible brokers", authorised by the Bank of England to borrow and lend government stock.

The term "Discount Market" is really a general one embracing all those whose chief business consists in dealing in sterling bills. The chief of these is the *bill-broker*. Originally, the function of the broker was to act as a go-between, but nowadays the bill-broker, pure and simple, is almost defunct. There are still, however, a few such brokers, known as "running brokers", who keep in touch with those having bills to sell (*i.e.*, merchants, accepting houses and foreign banks) and those who want to buy (*i.e.*, principally banks and discount houses). They arrange the sale of bills between the two parties and receive a brokerage for their services.

The more common type of bill-broker is the retailer dealer in bills, who buys bills outright but seldom holds them until maturity, selling them whenever he can make a profit through a change in discount rates. His specialised knowledge of bills enables him to differentiate very finely between the standing of the parties and also between bills maturing at various dates: he pays less for bills maturing at unfavourable times and more for those falling due at periods when monetary stringency is expected. This type of broker finances himself to some extent with his own funds, but principally with funds borrowed from the banks, who lend him money "at call" or "at short notice" against the security of parcels of first-class bills or gilt-edged securities.

One of the services performed by brokers is that of sorting and "grading" bills. They buy miscellaneous bills and sort them into bundles containing bills of *similar* maturities (*i.e.*, due dates) but of *mixed* names (so that there is not a preponderance of bills accepted or

endorsed by any single party). Bundles thus made up are readily salcable to the banks and other market dealers. Though the banks always satisfy themselves respecting the standing of the parties, the endorsement of the broker adds security to the bills he sells.

Bill brokers perform a valuable service to business men by enabling them to convert future credits into present money. They provide the banks with short-term assets that are eligible for inclusion in their minimum reserve requirements and they give firms with surplus cash a profitable short-term investment.

DEVELOPMENT OF THE "PARALLEL MARKETS"

The decline in the use of internal bills, at one time the main constituent of the business of bill brokers, led to an increase in their business in foreign bills, but with the decline in world trade, this business, too, declined. With the restriction in the circulation of commercial bills—the money market's long-established source of finance—a number of "secondary" or "parallel" markets grew up. Development of these new, secondary markets has been so rapid that the amount of short-term funds forming the dealings therein is greater than the amount dealt with in the established discount markets. Five such "parallel markets" are mentioned below.

- (a) *The sterling interbank market.* This is the largest of the new, "parallel markets" and involves over two hundred listed banks, *i.e.*, clearing banks and their affiliates, Scottish and Northern Ireland banks, merchant banks, Commonwealth banks having branches in the U.K. and others. Operations are based on placing money on deposit with one another on an unsecured basis for periods ranging from overnight to five years or more. This presents a highly-convenient alternative to the adjustment of liquidity requirements by traditional arrangements. The market exists, essentially, to provide banks with profitable methods of placing sterling deposits offered to them without much notice when they have little immediate need for them; additionally, it provides the banks with an accessible source of cash which can be drawn on for financing loans to customers.
- (b) *The market for sterling certificates of deposit (C.D.).* A sterling certificate of deposit is a negotiable instrument which certifies that a sum of money has been deposited with the bank which issues the C.D., at a fixed rate of interest and that the deposit will be repaid by the bank, on the stated maturity date, with interest. Discount houses and banks, industrial companies and other financial institutions are the principal buyers. The C.D.s

provide a useful method of raising a large volume of funds at a fixed rate of interest for periods which suit their buyers' needs; their advantage is that the money deposited for a sterling C.D. cannot be withdrawn before the date of maturity. C.D.s are bought and sold freely in the secondary market which has grown up around the London Discount Market Association members, money traders and others.

- (c) *The finance-houses deposit market.* This market is based on the clearing banks who have an interest in specialist hire-purchase finance companies, and some merchant banks. Bills of exchange are issued by finance houses and presented to acceptance houses, so that the security and marketability of the bills are increased. The accepted bills ("accommodation bills") may be bought by discount houses at face value, less a discount.
- (d) *The local authority market.* A local authority may be described as a public body authorised to levy taxes, *e.g.*, rates on local residents; its borrowing is secured on its rates and revenues. Local authority borrowing is based on: temporary loans, bank overdrafts, bonds, stock issues, mortgage loans and bills, which may be issued for periods of up to 12 months. The market is concerned with the provision of funds for local authorities for periods of less than 12 months; it has become a valuable collecting-point for short-term investment.
- (e) *The Euro-currency market.* (This market is also known as the "Eurodollar market".) Euro-currency deposits are made with banks and denominated in a currency other than the national currency of the countries in which the banks are located. Thus, the term "Eurodollars" could be applied to the case of an oil exporter in an Arab state who receives dollars from an American oil importing company and deposits them with a bank located in London. The dollars then become available for loans made by that bank. Deposits of this nature come largely from central banks, multinational firms, oil exporting states and private holders of currency. There is now an extensive and active market, centred on London's highly-expert financial institutions, based on lending and relending these currencies for periods of up to three months. Borrowers include, for example, companies engaged in the finance of foreign trade. (The market also provides longer-term loans for important capital projects in many countries.)

BANK OF ENGLAND CONTROL OF THE MONEY MARKET

The Bank of England's control of the money market rests upon the fact that the discount houses work to a large extent with borrowed money. If the Bank considers it necessary to curtail activity in the market, it takes steps to reduce the volume of money. Since 1971 there has been an informal understanding that the London Discount Market Association will bid for the weekly issue of Treasury Bills. As the discount houses work with funds borrowed from the commercial banks, if the supply of money is reduced they might not be able to borrow enough from the banks to take up the entire Treasury Bill issue. They must then go to the Bank of England which as lender of last resort will make funds available but it will do so at its own rate and this will be above its minimum lending rate. The discount house in these circumstances would be involved in losses; hence they try to avoid being "forced into the Bank". When there are signs of tighter money conditions, the discount houses raise their discount rates to their customers and so induce a reduction in the demand for discount facilities.

INTERNATIONAL ASPECTS OF THE MONEY MARKET

For generations London has been the leading monetary centre of the world and as a result there are many sections of the money market which have ramifications in all parts of the world.

ACCEPTING HOUSES. The function of these is to guarantee the due payment of debts, in return for a small commission, by accepting bills which are drawn upon them by the sellers of goods, instead of the sellers' drawing direct upon the buyers. If a French merchant, Lebrun, wishes to sell goods to Brown in Britain, but knows little of Brown's financial position, Lebrun may request Brown to open a credit with a bank or accepting house in London. If this is done, Lebrun, instead of drawing his bill on Brown, will draw it on the bank or accepting house, by whom the bill is accepted on the strength of Brown's promise to provide the necessary funds before the bill matures. The advantages reaped by Lebrun are that he is practically relieved of all anxiety as to the due payment for the goods he has sold and that he has no difficulty in selling his bill because the accepting houses have such a reputation for soundness and stability that bills drawn under credits opened by them can be negotiated without difficulty almost anywhere in the world.

The same principle holds good in the case of exports from Britain. A British exporter, Smith, may know little of the standing of a foreign purchaser, but if a bank or accepting house will open a credit in his

favour at the request of the foreign importer, Smith can proceed in safety with the shipment of the goods.

There has been an ever-growing tendency on the part of overseas banks and British commercial banks to enter into the acceptance business. This movement has been accelerated by the opening by the commercial banks of branches on the Continent and by the establishment of connections with foreign banks. The commercial banks have captured the greater part of the acceptance business on behalf of British firms and have also acquired a large share of the business with certain leading financial centres such as New York, Paris and Zurich.

CHAPTER THIRTY-NINE

The Capital Market

Capital is required by a business for three purposes—to enable it to begin operations, to help it to carry on its transactions and to assist it to expand. These requirements are met by the *Capital Market*, which may be considered as consisting of an inner and an outer ring.

THE INNER CAPITAL MARKET

This market includes the *market for new securities*—comprising merchant banks, finance companies, issuing houses, company promoters, underwriters and brokers—and the *market for invested capital*, *i.e.*, the stock exchange. The function of this market is to facilitate the flow of capital from those who have it to those who need it. The market for new securities directs the demand for new capital by expressing it in the form of securities adapted both in amount and the degree of risk to appeal to a widespread investing public. Underwriters may guarantee the subscription of the whole or part of an issue; brokers of repute lend their names to prospectuses and open up a market among their clients; bankers receive subscriptions and in return issue securities; while the issuing houses carry out publicity in connection with the issue.

The work of the market for invested capital, *i.e.*, issued securities—the stock exchange—is an important adjunct to the function of obtaining supplies of new capital from the public. This purpose it serves by providing facilities by which securities, when purchased, may readily be exchanged among the people who hold them. The organisation of the inner capital market as a whole enables an immense aggregate of small capital holdings to be collected from a wide range of investors and placed at the disposal of municipalities, industrial concerns and commercial enterprises of all kinds.

THE OUTER CAPITAL MARKET

The outer ring, much less centralised and organised, includes building societies, insurance companies, pension funds and others dealing in long-term borrowing and lending. The inner market plays such a prominent part in linking the demand for capital with its supply that the extent to which industry is financed through these less defined agencies is often overlooked. Professional money lenders make loans

of varying amounts to all types of individuals; business men raise large sums from building societies and insurance companies on mortgage, while in many industries short-term capital is supplied by the system of trade credit through a variety of merchants, dealers and middlemen.

Into this section of the capital market also come the operations of Finance for Industry Ltd, the Estates Duties Investment Trust Corporation (Edith) and the Agricultural Mortgage Corporation Ltd.

THE MARKET FOR NEW SECURITIES

The foremost institutions in the market for new securities are the sixty *issuing houses*, usually merchant banks, whose business it is to arrange for public issues of new shares and stocks in companies, corporations and governments. The success of a public issue depends largely on the reputation of the issuing house which sponsors the issue and sometimes such a house may itself take over the whole issue and resell to the public at a profit.

THE ISSUING HOUSES

One of the main functions of the *issuing houses* is to offer loans and capital issues to the investing public, including issues on behalf of overseas undertakings.

Issuing houses act as pipe-lines between the investing public's idle resources and industry. They examine the merits of the proposed issue of capital and then decide whether the issue is warranted by the position of the company or other body wishing to raise money, whether the security given is good and whether there is a reasonable likelihood of the public getting a fair deal.

The issuing house does not guarantee the issue which it sponsors; but it will not sponsor an issue which it considers to be doubtful. In preserving its own good name it protects the public, and thereby facilitates the rapid and economic transfer of capital. In discharging these functions the issuing house achieve greater efficiency from the fact that there is a good deal of specialisation among them as to the type of issue handled. Some concentrate on domestic issues, others specialise in overseas issues; some devote themselves solely to "safe" issues and others are connected mainly with issues of the essentially speculative type.

OTHER METHODS OF LONG-TERM FINANCE

Large well-established companies make issues direct to the public without resort to an issuing house and where the issue is small new

capital may be raised by a *private placing* with an *institutional investor* such as an insurance company, through a stockbroker. Private placings are usually made by public companies with no stock exchange quotation and by private companies.

Large companies can raise new capital by a *rights issue* to existing shareholders. In this way costs of advertising and the services of an issuing house are avoided. Although a public company in need of long-term capital will usually have resort to an issue either of shares or debentures, by no means all businesses are public companies. The private company, the individual trader and the partnership are common, and some of the most prosperous concerns are privately owned.

How, then, do these concerns satisfy their capital requirements? In the first place, despite the fact that, theoretically, banks lend only short-term capital, there is no doubt that in practice many loans by banks to private traders are in effect loans of long-term capital and not merely of working capital. But to a still greater extent private businesses obtain fresh capital from loans arranged with business associates; other sources of supply are the building societies and insurance companies. Private traders and partnerships have also open to them the possibility of taking other persons into partnership, thereby acquiring new blood and new capital.

Probably the steadiest flow of capital into private concerns is that which comes from the *reinvestment of profits*. This is possible, of course, only when profits are sufficient to yield a surplus over and above what is required by the proprietors for their own personal needs. A parallel procedure, where public companies are concerned, is the transfer of part of the profits to "reserves" instead of its distribution as dividends.

INVESTMENT TRUSTS

The term "investment trust" is misleading as there is no "trust". Investment trusts are registered companies; they invite subscriptions from investors for their shares and debentures and apply the funds subscribed in a wide selection of investments. Investors in the trust thus obtain the benefits of diversification, so that a possible loss in one direction may be offset by a possible gain in another. Generally the directors have full power to change investments as they think fit. The shares of the more important investment trust companies are quoted on the Stock Exchange and can be bought and sold through a stockbroker in the ordinary way. The profits of the trust, derived from returns on investments, are distributed in the form of dividends to the shareholders. Profits from the sale of securities are reinvested. Liqui-

dity is the fundamental principle underlying a trust's investments and this is best secured by holding a wide variety of securities, with certain exceptions, *e.g.*, trusts of insurance shares.

Investment trusts are connected with certain merchant bankers with whom they often have interlocking financial interests. They have a stabilising influence on the stock exchanges and make the liquid funds they hold available to long-term borrowers.

UNIT TRUSTS

Unit trusts are like investment trusts in that they give the small investor an opportunity to acquire an interest in a wide range of investments, but they are constituted in an entirely different way. The basis of the arrangement of the unit trust is a trust deed between the management company, which will manage the trust, and a trustee corporation (usually a bank or an insurance company) through which the managers invite subscriptions from the public (the subscribers becoming unit-holders). The funds subscribed are used to buy a portfolio of investments which are held by the trustees on behalf of the unitholders.

Managers have the power to eliminate securities that show weakness and to replace them, with the approval of the trustees. These unit trusts are known as *flexible trusts*, most of them spreading their investments widely over several markets (*e.g.*, gilt-edged, industrials, banking, property), but some specialise, *e.g.*, in banking and insurance shares and thus secure the benefit of the insurance companies' own skill and diversification in investment. The tendency towards specialisation has, however, become more marked—one unit trust invests more than half its funds in gold-mining shares—thus introducing an element of speculation.

A few unit trusts are quoted on the Stock Exchange. Apart from these, investors must either apply when blocks of units are offered by the managers for public subscription or they must buy from the managers who quote daily buying and selling prices based on the market quotations of the underlying securities.

Only authorised unit trust schemes, *i.e.*, those certified by the Department of Trade as complying with regulations in the *Prevention of Fraud (Investments) Act 1958*, are allowed to advertise. The regulations prescribe a substantial capital requirement for trustees (who must be independent of the managers), require the disclosure of the initial and annual commissions of the managers, and they also govern the calculation of managers' buying and selling prices.

There are important differences between investment and unit trusts, arising mainly from the fundamental one of constitution. The

investment trust has its own capital structure; if it raises part of its funds by the issue of prior stocks—debentures and preference shares—the investor in its equity (ordinary) shares gains the benefit of its capital gearing but the investor in a unit trust has not this advantage. Another difference is that the unit trust distributes the whole of its income half-yearly, but the investment trust follows the practice of companies of ploughing back part of its profits for expansion and of retaining part for the purpose of dividend equalisation; if the management is skilled this may be to the long-term advantage of the investor. An important difference is that, though in the unit trust control by the trustees and by the Department of Trade provides safeguards against serious malpractices, unit holders do not meet and have no control over managers, whereas investors in an investment trust have the usual powers of shareholders and can exercise their powers in general meeting.

FINANCE COMPANIES

These organisations, sometimes called finance houses, hire-purchase finance companies and industrial banks, finance the hire purchase of consumer and capital goods. The bulk of the business is in the hands of the 31 members of the *Finance Houses Association*. Their funds are obtained from their own capital (about 20 per cent), deposits of the public (about 50 per cent) and the rest from bank loans and bills discounted. The clearing banks have a considerable interest in finance houses.

INSTITUTIONAL INVESTORS

A considerable supply of long-term capital comes from insurance companies and pension funds which accumulate funds from regular insurance premiums and pension fund contributions. Inflows of funds exceed outflows and the surplus is invested in existing securities and in new issues.

THE COMPANY PROMOTER

The majority of public companies obtain their initial capital through the operations of the company promoter. The promotion may be carried through by a parent company interested in the formation of some subsidiary or allied business, by the vendor of the assets to be purchased by the new company or by a financier who specialises in the flotation of new companies. The last is the most usual form. It is the promoter who attends to the preliminary details necessary before

a company can commence business. He induces suitable persons to act as brokers to the issue—since the standing of the broker whose name appears on the prospectus gives some indication of the soundness of the new issue. Not the least of his duties is to make arrangements for *underwriting*. He is in touch with persons who are willing to act as guarantors of the success of a public issue, and with them he enters into agreements for underwriting the issue of capital or debentures.

UNDERWRITING NEW ISSUES

Large issues are almost always *underwritten*; that is to say, the financial houses or promoters concerned in the flotation make arrangements with banks, insurance companies or other large investors, each of which agrees to be responsible for a certain amount of the issue, so that if the whole issue is not subscribed by the public, each underwriter will take up and pay for his proportion of the balance. For this service the underwriters receive an *underwriting commission*.

In some cases underwriters particularly anxious to secure a certain amount of the security issued will *underwrite firm*—that is to say, they apply to have the amount allotted to them in full irrespective of the amount subscribed by the public. They thus get their commission *and* the stock applied for.

THE STOCK EXCHANGE

A stock exchange is *a market for the purchase and sale of issued stocks and shares*. Buyers and sellers within the exchange, and also buyers and sellers on different exchanges, are in direct communication with one another by telephone, telegraph and cable. The methods of quoting shares, of making bargains and of settling transactions are definitely fixed and widely known; prices are speedily circulated, extensively quoted and easily understood, while the high business standard that exists throughout the market is far more effective than the strictest legal control for preventing fraud and minimising risks. The stock exchanges are perhaps the best organised of all markets.

THE LONDON STOCK EXCHANGE

Although there are stock exchanges in the leading provincial cities of Britain, the largest and most important in the country is the London Stock Exchange, which was founded at the beginning of the nineteenth century. It has its place of business, or "House", in Throgmorton Street, London, E.C.2, and is in close touch with other exchanges not only in the provinces but also overseas.

In point of fact, the London Stock Exchange is not a single market but a collection of markets, for different classes of shares are by custom dealt in on different parts of the floor of the House, and the dealers in each particular class of shares gather in their own corner to do business. Today, 8,400 securities are officially listed on the Stock Exchange; of these over 2,600 represent the equity capital of U.K. companies. A new market in "traded share options" opened in 1978.

THE GILT-EDGED MARKET

An important part of the Exchange is the Gilt-Edged Market, which covers dealings in first-class securities such as Government Stocks, of the United Kingdom and certain Municipal and Commonwealth Stocks. These are considered to be absolutely safe. Government Securities account today for around 60 per cent of the nominal value of listed securities, and almost 80 per cent of the total value of turnover.

Movements in the prices of gilt-edged securities may arise from a variety of causes. A rise in money-market interest rates will result in a fall in the price of gilt-edged securities, thereby levelling up the yield from a purchase. Political events, too, are reflected in the gilt-edged markets as also are changes in the general outlook.

CONTROL AND MANAGEMENT

The London Stock Exchange is a voluntary association of the proprietors of the Exchange building, who meet there to deal in stocks and shares under the rules laid down by the *Council of the Stock Exchange*, comprising 46 elected members. The Government Broker, who represents the Bank of England is a member *ex officio*. There are about four thousand members (belonging to some 276 firms) who, together with their clerks, alone may enter the House and deal "on the floor".

Members may be suspended if they break or fail to comply with the rules or are guilty of dishonourable conduct. A member who fails to meet his obligations is "*hammered*" and posted as a defaulter. "*Hammering*" is an ancient custom which consists of an official of the Exchange mounting a rostrum on the floor of the House and tapping with a hammer somewhat similar to an auctioneer's hammer. When the attention of members has been obtained, the defaulting member's name is announced, together with the fact that he is unable to meet his obligations, and the name is afterwards posted on the House notice-board. Any losses to the public arising from such failures are

made good from a *compensation fund* under the control of the Stock Exchange Council.

Disputes among members must be referred to the Council for settlement and members are prohibited from taking legal action against one another without the consent of the Council.

MEMBERSHIP OF THE EXCHANGE

Membership is strictly regulated and entry is not easy. Members are of two classes:

- (1) **JOBBERs**, who actually buy and sell stocks and shares. By the rules of the Exchange, jobbers may do no business direct with the public, and deal only with other jobbers and with brokers. They make their profits from the difference between the prices at which they buy and sell the same stocks and shares. A jobber may not enter into partnership with a broker.
- (2) **BROKERs**, who buy and sell on behalf of members of the public and charge a commission (or brokerage), fixed by the rules of the Stock Exchange for their services.

Apart from the jobbers and brokers themselves, who are members of the Exchange, transactions are also carried out by persons known as *Authorised Clerks*, who are employees of stockbroking firms, and are authorised to make contracts (*i.e.*, to buy and sell) on behalf of their employers. These are distinguished from *Unauthorised Clerks*, who are privileged to enter the House to assist their employers, but are not authorised to deal for them.

ELECTION TO MEMBERSHIP. No member may be elected unless he has obtained a nomination, either from a retiring member or his estate or, in special circumstances, from the Council of the Stock Exchange itself. Nomination is in itself no guarantee of election. A member must be at least 21 years of age and must have served at least 3 years with a member firm. He may be of any nationality.

JOBBERs AND BROKERs

The functions of jobbers and brokers are quite distinct. The broker is an intermediary who acts *as an agent* for his clients, *i.e.*, the public, jobbers and other brokers. The jobber is a *principal* and acts on his own behalf. The broker undertakes to buy or to sell stocks and shares *through a jobber or jobbers*. The jobber is peculiar to the London Stock Exchange.

The fact that the jobber is generally ready to quote a double-barrelled price for buying or selling any of the securities in which he

specialists tends to prevent wild breaks in prices. On other exchanges a rush to sell a particular security may result in a fall which is often entirely disproportionate to the true fall in value, simply because no buyers can be found; similarly, heavy "bulling" (see page 252) in a security brings about an exaggerated rise which must be adjusted by a subsequent fall. On the London Stock Exchange, however, the jobber smooths out these wild fluctuations. If selling is expected in a certain security he "marks down" his prices in anticipation, but the margin between the selling and buying prices which he offers must not be too large, otherwise brokers will look askance at him. It is not simply the existence of the jobber which is of such great value, but rather the fact that he will *make a market* in securities by quoting a double-barrelled price *without knowing whether the inquirer will turn out to be a buyer or a seller*. Thus, the broker merely asks: "What are Shell?" The jobber will reply, for example: "550 to 553p", implying that he will buy at 550p or sell at 553p. The difference between the prices at which the jobber buys and sells is known as the *jobber's turn*.

The jobber fixes his price with reference to ruling market-prices and with a view to "keeping his book square". Sometimes, of course, he deliberately takes up a position in a given security, in the hope of making a profit from a movement in the price; but usually he fixes his price so as to even up his purchases and sales. If he finds he is holding too much of a given security he will have to lower his price to encourage purchases and discourage further sales. If, on the other hand, his position in a certain security becomes "oversold", he must raise his price to encourage brokers to sell to him. In this way the jobbers take up the slack on the market by regulating their prices to reflect market conditions. Unless a broker discloses the amount of stock involved before the jobber quotes, the jobber is not committed to deal at the quoted prices in an unusually large amount.

PROVINCIAL STOCK EXCHANGES AND OUTSIDE BROKERS

There are stock exchanges in the principal cities of the United Kingdom and Ireland, and brokers in smaller centres may be members of the Provincial Brokers Stock Exchange. These and the London Stock Exchange have formed the Federation of Stock Exchanges for the purpose of establishing uniform requirements for official quotations and other matters.

There are also firms of stockbrokers who are not members of any Stock Exchange. Some of them have big businesses and have a good reputation and prefer to remain outside the Stock Exchange, but unless they are exempted in some way, they must take out a principal's

licence from the Department of Trade under the provisions of the *Prevention of Fraud (Investments) Act 1958*.

PERMISSION TO DEAL AND OFFICIAL QUOTATION

Under a London Stock Exchange rule (other Stock Exchanges have a similar rule), members are permitted to deal on the Exchange only in securities for which an official quotation has been granted, securities of local authorities and public boards, securities quoted on certain other Exchanges, and bargains for which special permission has been obtained from the Council. For most securities, therefore, permission to deal and official quotation are practically synonymous. When an official quotation has been granted, the security is included in the Exchange's Official List.

Since there is no ready market for unquoted shares, investors always see that a company's prospectus, offering shares for public subscription, bears at the head the usual statement, "Application is being made to the Council of the Stock Exchange (London) for permission to deal in and an official quotation for the within-mentioned shares." With the application the company must submit to the Exchange, through its brokers, information about the company, its directors and the circumstances of the issue, so that the Exchange can ensure that the company is providing all the information necessary to enable prospective investors to assess its prospects fairly; that its regulations contain nothing unreasonable; that it is complying with current practice in the form of the various documents to be used in the issue; and that it will provide all the usual facilities for dealing in the shares. The permission when granted relates only to the issue in question; a further application must be made for a quotation for other shares or debentures.

In the first instance the company must provide for inspection its certificate of incorporation, its certificate to commence business and copies of its memorandum and articles of association. To satisfy the Exchange the articles must provide that fully-paid shares shall be free from lien and from any restriction on transfer; that share certificates shall be under seal; that the directors' powers of borrowing on behalf of the company shall be limited to a reasonable amount; that preference shareholders shall have adequate voting power in appropriate circumstances; and that appointments of directors made by the board to fill casual vacancies shall be only until the next annual general meeting when the members may reappoint them or reject them.

The directors must provide the Exchange with a *general undertaking* on numerous matters, intended mainly to ensure that share dealings are facilitated and that proper information is given promptly to members and to the Exchange.

Proofs of the prospectus and of all documents relating to the issue—allotment letters, share certificates, etc.—must be submitted to the Exchange for approval. The reports, contracts, valuations, etc., mentioned in the prospectus must be submitted for inspection. The prospectus itself must contain information beyond that required to satisfy the requirements of the *Companies Acts*; in particular, the accountants' reports must cover a period of ten years, and the prospectus and related documents must be made available for inspection at an address in the City of London for at least fourteen days.

When the application relates, not to shares being offered to the public by prospectus, but, for example, to shares being "placed" with brokers' clients without a prospectus, the Exchange requires an advertisement giving similar particulars to be inserted in two London financial papers, so that the information will be available to the investing public.

Applications are considered by the Council's Committee on Quotations and are not granted until the prospectus has been in the hands of the public, as sometimes useful information respecting the company or its directors is communicated to the Exchange in this way. Under the *Companies Act* 1948, the allotment of the shares concerned becomes void if application is not in fact made to the Exchange or if it is not granted within a certain time-limit. As soon as possible after the quotation is granted, a declaration must be made to the Exchange that all legal requirements have been observed, that purchase of all properties to be purchased out of the proceeds of the issue has been completed and the purchase money paid, and particulars of the numbers of shares applied for and allotted must be given. Until this is done the company's particulars in the Official List are printed in italics.

By conducting this detailed investigation, the Stock Exchange endeavours to protect the investing public by satisfying itself of the *bona fides* of the company and of the circumstances surrounding the issue. From time to time the requirements of the Exchange for quotation are strengthened and a quoted company coming to the Exchange for quotation of a further issue is required to amplify its general undertaking accordingly. When the Exchange considers circumstances warrant the step, it suspends or revokes the quotation of a stock and dealings cease.

OFFICIAL LIST

The prices of shares and debentures of companies which have obtained an official quotation are published in the Stock Exchange Daily Official List every business day at the close of business. The list shows

the two prices at which the securities could be bought or sold. In another column is given a list of prices at which dealings have taken place during the day. The prices appearing in this column are collated by officials in charge of the marking boards from slips which are handed in by brokers and which indicate the prices at which bargains have been done; such bargains are said to be *marked*.

The nominal amount, that is, the face value of a security, is called the *par* value, and, if the price quoted is exactly the face value, the security is said to stand at par; if the price is above the face value, it stands at a *premium*, and, if below, at a *discount*.

SECURITIES: BEARER, REGISTERED AND INSCRIBED

The securities dealt in on the Stock Exchange may be variously classified: they may represent shares in a company or bonds of indebtedness of a company, municipality or nation. In either case the securities fall into three broad classes. These are:

- (1) **BEARER SECURITIES** (bearer bonds, bearer stock, share warrants to bearer), the property in which passes with mere physical possession, and transfer of which on sale is effected by mere delivery.
- (2) **REGISTERED SECURITIES**, which are the property of the persons entered as owners in the register of the issuing body. The owner of registered stock or shares receives a certificate made out in his name, stating that he is the owner of such and such stock or shares, the nominal value being given as well as the numbers of the shares. When an owner of registered securities sells them, he signs a document known as a *stock transfer form*, and this, with the share certificate, is passed to the buyer or his broker; particulars of the buyer are inserted and both documents are lodged at the office of the issuing body so that the necessary alterations may be made in the register. Then the old certificate is cancelled, and a new one made out to the purchaser.
- (3) **INSCRIBED SECURITIES**, for which no certificate of any kind is issued. The names of the owners of such stock are inscribed in registers kept, usually, at a bank, frequently the Bank of England. When such stock is sold, the seller attends personally at the bank to sign a transfer and must be accompanied by a member of the Stock Exchange to identify him. If the seller cannot attend, he must give a legal power of attorney to some other person to take his place. Very few stocks are now in this form.

PRICES OF STOCKS AND SHARES

The prices of stocks and shares fluctuate widely. The causes of fluctuations are varied but they can be grouped under four headings:

Specific—the prevailing market view of the prospects of a particular company or industry;

Economic—inflation, production trends, monetary conditions, the balance of payments position, company results in general;

Political—legislation affecting commerce and industry (actual or proposed), budgetary problems;

International—national policies affecting trade, instability in a major country.

Share prices are usually an index of investors' confidence rather than an estimate of the net worth of a company. Short-term fluctuations can occur for technical reasons, *e.g.*, profit-taking or adjustment of positions before settlement (see below). As the amount companies can pay in dividends is limited by their profits, share prices will tend to fall in times of high interest rates for the same reason that fixed-interest securities will. If only a small quantity of business is being transacted in the market, a buying or selling order will have a more marked effect on prices than on a day when trading is brisk.

MARKET PRICES are the prices at which the shares have been bought and sold "on 'Change". These prices are published each day in the Stock Exchange Lists, and reproduced in some daily papers.

STREET PRICES are those prices at which stocks and shares are bought and sold in Throgmorton Street outside the House, *i.e.*, in the so-called "Street Market", where, at busy times, buying and selling may go on after the Exchange is closed.

TAPE PRICES. The Exchange Telegraph Company installs and operates in the offices of subscribers a machine which reproduces on tape current news messages sent out from its headquarters, and this method is widely used for sending out particulars of Stock Exchange prices throughout the day as deals take place.

Prices quoted on the London Stock Exchange nearly always include all accrued interest or dividend on the securities concerned. Thus, although securities may be bought only a short time before a half-year's interest is due, the purchaser will be entitled to receive the whole of that half-year's interest from the company (or Government, etc.). A short time before interest is due (generally about a fortnight), a company will close its books to any further transfers of its securities until the interest has been paid. Consequently, a buyer at this time will not be registered as owner, and the company will pay the

interest to the seller. The buyer must, therefore, see that his stock-broker obtains payment of the interest from the seller and hands it over to him (the buyer). In such circumstances the purchaser is said to buy the security *cum dividend*, or, shortly, *cum div.*

A few days after the closing of the books, however, on a day fixed by the rules of the Exchange and varying with the type of security, prices of the security are quoted *ex dividend* (*ex div.* or *x d.*), and the buyer is then not entitled to the interest or dividend, which remains the property of the seller.

The prices of some short-dated Government securities and Treasury Bills are often quoted *firm* or *clean*—that is to say, the buyer has to pay, in addition to the quoted price, the proportion of interest accrued to date since the last interest payment. In America and Continental countries prices of fixed-interest-bearing stocks are generally quoted *firm*, but this does not apply to ordinary stocks and shares on which the dividends may vary.

Besides the interest or dividend, companies requiring additional capital may give their shareholders the right to take up other shares within a certain period at a certain price somewhat below market price. This right is valuable and can be sold separately from the shares; the shares are either sold with the rights (*i.e.*, *cum rights*) or they are sold *ex rights*.

Where shares are sold "*ex all*" the buyer obtains no rights other than to the shares themselves, and any claim to dividends or rights attaching to the shares remains vested in the seller. The price of *shares* is quoted as so much *per share*, whilst stock is quoted as so much per £100 of stock.

DEALINGS "FOR CASH" AND "FOR THE ACCOUNT"

Dealings on the Stock Exchange may be either "*for Cash*" or "*for Account*". The only difference between the two classes is that in the former case actual delivery of the securities and payment for them takes place as soon as possible after the deal has been concluded, whereas deals on the latter basis are not settled until the arrival of the next Account Day. Dealings in Government securities are for cash and dealings for stocks and shares of companies are for the account.

THE SETTLEMENT

A "Settlement" takes place once a fortnight (or once every three weeks in certain cases) and is spread over one week and two days, from the Monday of one week to the Tuesday of the next. *Contango Day*, the first day, is that on which the parties to a transaction decide

whether the bargain should be completed or held over till the next settlement. The latter course is taken in cases where it is not desired to pay over the money or to deliver the securities immediately. The charge for the privilege of postponement, which usually has to be paid by a buyer unable to hand over the necessary money, is called *Contango*; in some cases, however, an allowance known as *Backwardation* might be paid to buyers carrying over, the allowance being charged to sellers failing to deliver.

Tuesday is *Making-up Day*, on which the Stock Exchange fixes making-up prices, *i.e.*, the prices at which shares are to be carried forward.

The third day of the settlement is known as *Ticket* or *Name Day*, when tickets which used to show the buyers' names are handed over by buying brokers to selling brokers, so that transfers can be made out.

The fourth and fifth days of the settlement are known as *First* and *Second Intermediate Day*, when documents are prepared for the completion of the transactions. The *Third Intermediate Day* is the second Monday of the settlement.

Settlement Day or *Account Day* is the last day when payments are finally made either for completing transactions or for carrying over bargains to the next settlement.

Buyers and sellers (including the public) can continue (*i.e.*, carry-over) their bargains from account to account at rates of interest charged or offered by the market. Brokers may do *contango* business only with jobbers (and not with each other). Continuation positions must be disclosed by jobbers to the Council half-yearly.

HOW SECURITIES ARE BOUGHT AND SOLD

When a broker receives an order to purchase, say, £1,000 of X Stock, he asks a jobber who deals in that class of security to "make a price" for the stock in question, without indicating whether he wishes to sell or buy. The dealer informs the broker that the price "is called" (say) 101-102, *i.e.*, that he will buy the stock at 101 and will sell at 102.

The first price quoted will usually be too wide, *i.e.*, the margin between buying and selling prices will be too great, and the broker will ask for a closer price, until finally a price is agreed at which the jobber will sell and the broker will buy. When this stage is reached, possibly when the price has narrowed to $101\frac{1}{4}$ - $101\frac{3}{4}$, the broker will close with the jobber and indicate that he is a buyer. No written contract passes at the time between the broker and the jobber, the transaction being merely entered in a dealing or jobbing book. The broker may, however, wish to have the transaction "marked", in

which case particulars of the transaction are written on a slip which is placed in a box and the details later posted on a board and published in either the Official or the Supplementary List issued on the following day.

The broker's clerks enter the transaction in a journal or Day Book, and a *Contract Note* is made out bearing the date, the name and address of the broker, the particulars of the stock, amount and price agreed upon, the commission (brokerage) charged by the broker, the amount of the contract stamp, the amount of the transfer duty and the registration fee payable to the company for registering the transfer. This contract note is sent to the client. The bargain is checked next morning by the broker's and jobber's clerks who confirm to each other particulars of the deal.

When the Settlement arrives the broker passes to the jobber, on Ticket Day or Name Day, a ticket showing his own name as immediate payer for the stock. The jobber might have bought the stock during the account through a selling broker. The ticket arrives finally in the hands of the selling broker, who makes out a form of transfer, has it signed by the seller, and passes it, with the certificate of the stock, direct to the buying broker, who pays for the stock, enters his client's particulars on the transfer, and registers the transfer with the company, which, in due course, forwards a new certificate in the name of the buyer.

SHARE TRANSFERS

Mention has been made of the share transfer which must be prepared and forwarded to a company when any of its shares are being transferred. The *Stock Transfer Act 1963*, introduced a simple form of transfer to replace the old "Common Form" of Transfer that was compulsory for companies desiring an Official Quotation. The Stock Transfer Form must be accepted by the registrars of virtually all Government, municipal and paid-up registered company stocks and shares. Exceptions are Government securities issued by the Post Office (*i.e.*, those on the Post Office Register and National Savings Certificates), building society securities, and companies whose liability is either unlimited or limited by guarantee. The requirement overrides any stipulation in the articles or governing regulations of the body concerned.

SPECULATION ON THE STOCK EXCHANGE

Transactions on the Stock Exchange are not confined to purchases and sales of securities for investment purposes. Many deals are purely

speculative in character, the dealers having no intention of taking or making delivery.

BULLS are speculators who buy stock in the hope of a rise. For example, Brown, a bull in Industrials, may buy Central Aeroplane Shares at £1 because he expects a rise in their price. The contract is duly made, but no money passes till settlement day. If in the meantime the market quotation rises to £1.10, Brown can either take up his shares by paying for them with a view to holding them for a further rise, or he can sell out and take his profit.

BEARS are speculators who sell stock in the hope of a fall in price. If the fall takes place, they can then buy in more cheaply than they sold and thus make a profit on the combined deals.

Naturally, both bull and bear are sometimes wrong in their forecasts and they find that prices move against them, *i.e.*, they go down for the bull or up for the bear. In such a case they may find it necessary to "carry over" their bargains till next settlement day.

When a bull carries over, he gets the jobber from whom he bought the stock to hold it till next settlement day. Suppose he bought a certain stock which, instead of rising, falls; he will then have to pay the jobber the difference between the purchase and ruling price and *contango*, *i.e.*, the charge for carrying over the purchase of the shares to the next Account.

A similar thing happens when a bear carries over, but the procedure is, of course, in the opposite direction. This charge is called *backwardation*.

OPTION DEALING is another form of Stock Exchange speculation. Options are right to buy or to sell within a stated period a definite amount of a specified security at a price fixed when purchasing the option, known as the "striking price". A "put" option is a right to sell; a "call" option is a right to buy; a double or "put and call" option is a right to buy or sell as decided by the option-holder when the time arrives. An option-holder does not have to exercise his option; if he does not do so, it lapses. Under the rules of the Stock Exchange the option can be exercised on one day only (the "declaration day") in each account and the maximum period for an option is three months. Though they are used for speculation, options can be used to limit the amount an investor must pay for a security he intends to buy. He purchases a call option and if the price of the security rises more than the cost of the option, he exercises the latter. If the price falls, he purchases on the market and abandons his option.

A **STAG** is a speculator who subscribes to a new issue with no intention

of retaining any shares or stock allotted to him, but in the hope that it will be over-subscribed and rise to a premium so that he can sell out at a profit before he has to pay up the remaining instalments.

YIELDS; TIMES COVERED; P/E RATIO

The annual return from an investment (by way of dividend or interest) expressed as a percentage of its market price or cost is known as the *yield*. (As the purchaser pays brokerage and contract stamp duty and, in the case of a company's shares, transfer stamp duty, these expenses should be included in the cost but for normal purposes of comparison of yields from different investments this is not done.) This is the *flat yield* or *gross running yield*; if income tax at the standard rate is deducted the result is known as the *net running yield*.

Fixed interest stocks are often redeemable at fixed dates at par or at some near figure, *i.e.*, 102, whilst the stock may have been purchased at say 90; a profit (or loss) on redemption would increase (or decrease) the yield over the intervening years and the annual yield per cent so adjusted is known as the gross (or net) *redemption yield*. Turning to equity stocks such as ordinary shares, the dividend, expressed as a percentage of the cost or market price, is known as the dividend yield. But an important consideration is the extent to which the dividend has been covered by the "earnings" for the year.

The term "earnings", in this sense, means the gross profit of the company less corporation tax at an assumed rate (say 40 per cent) less the gross amount required to pay any preference dividend. So if a company has a capital of 80,000 ordinary shares of £1 each and 30,000 6 per cent preference shares of £1 each, and has a profit after providing for corporation tax of £21,800, this will permit the payment of the preference dividend (which will absorb £1,800) and leave £20,000 "*earned for ordinary*" or "*earnings*". This would permit a dividend of 25 per cent or £0.25 per share, but assuming a dividend of 12½ per cent is paid, the "*times covered*" figure is 2.0. If the market price of the shares is £3, the dividend yield is $\frac{£0.125}{£3} \times 100 = \frac{12.5}{3} = 4\frac{1}{3}$ per cent whilst the earnings yield is twice this rate.

The ratio of the market price (£3) to the earnings yield (£0.25) is known as the *price/earnings* or *P/E ratio* (in this case 12.0). It expresses the market price of the share as the number of years' purchase of current earnings. The P/E ratio is widely used as a method of comparing the "deariness" of different shares.

CHAPTER FORTY

The Foreign Exchanges

The Foreign Exchange Market provides the machinery for the settlement of international, as distinct from national debts. The settlement of international indebtedness is, however, complicated by the fact that different nations have different units of money and that consequently it is necessary to establish a ratio or rate of exchange between the different units so that a sum payable in one country's currency can be satisfactorily translated into the currency of another country.

The London Foreign Exchange Market has no central venue. It comprises two classes of persons—dealers and brokers—who conduct their business from various offices in the City.

The *dealers* are mainly the operators in the foreign exchange departments of the banks through which all dealings with the public take place. There are also several firms of foreign exchange dealers in the City. The dealers do not usually transact business with one another direct; nearly all market deals are carried out through the intermediary of various firms of *brokers*, who charge a small brokerage for their services. Each of these brokers specialises in one group of currencies.

HOW INTERNATIONAL INDEBTEDNESS IS DISCHARGED

Bills of exchange enable debts due from one country to another to be settled without any transfer of coin or bullion. There are, in general, two ways in which they may be used:

- (a) The creditor may draw a bill on his debtor and either sell it to his bank for its face value less discount or hand it to his bank with instructions to present it for payment and collect the proceeds.
- (b) The debtor may buy a bill payable in the currency of the creditor—usually a cheque or sight-draft drawn on a bank in the creditor's country—and remit it to the latter in settlement.

Thus, a debt due from France to Britain may be settled by the French bank through its branch or agent either by a sale of francs in London or by a purchase of sterling in Paris.

THE BASIS OF EXCHANGE RATES

As in the case of any other commodity, the value of one foreign currency in terms of another (*i.e.*, the rate of exchange) is determined, apart from Government controls, by demand and supply.

The Purchasing Power Parity Theory seeks to show that the factors affecting demand and supply so adjust themselves that the exchange rates tend to rest at what is known as *purchasing power parity*. According to this theory, if a representative block of goods cost £1 in England and 9.00 francs in France, the purchasing power parity between French and English currency is 9.00 francs per £, and the rate of exchange will tend to rest at this figure. However the theory has been severely criticised because it is not possible to set up a representative block of goods, and political and other factors interfere with the direct comparison of prices.

To maintain the equilibrium of the official exchange rate, the central authority controls the supply of foreign exchange *directly*, by insisting that currency dealings shall be transacted only by authorised agents for the central bank, and *indirectly*, by regulating imports, thus limiting the domestic demand for foreign exchange in respect of liabilities incurred abroad. Control is also exercised over the export of capital and exports are encouraged to increase the amount of foreign currency earned.

It is a major objective of Governments in countries with officially fixed exchange rates, *i.e.*, rates not free to fluctuate because of Government control, to maintain conditions whereby claims by and against their nations *vis-à-vis* foreigners tend to balance at the prevailing rates. This entails constant interference with the free working of the economy.

DEVALUATION

This is a lowering of the value of the currency in terms of other currencies. It might be undertaken in order to correct a disequilibrium in the balance of payments, thereby stimulating exports (which become cheaper to other countries) and discouraging imports (which become dearer to the devaluing country). In this way a balance of payments deficit can be wiped out or reduced.

When a currency is valued at a higher value than is justified by the difference between its internal and external values, it is said to be *overvalued* on the exchange market while other currencies are *undervalued* in terms of that currency. When a currency is overvalued its exports tend to fall and its imports to increase and when a currency is undervalued, its exports tend to increase and its imports to decrease.

Sterling Devaluation. This took place in September, 1949, when the pound sterling had become overvalued in terms of the U.S. dollar. Falling exports, due to a large extent to high sterling prices, and rising imports resulted in an ever-increasing dollar shortage and a severe drain on British gold reserves and to remedy the position the £ was devalued from 4.03 to 2.80 dollars, and again in November, 1967 to 2.40 dollars.

The pound again came under severe pressure and from 1972 official control of the rate of exchange ended. The pound was allowed to "float" and market conditions allowed to determine the rate of exchange.

OFFICIAL EXCHANGE RATES

When the gold standard operated rates of exchange were determined by the comparative gold equivalents of two currencies. Official rates of exchange are sometimes expressed in terms of the U.S. dollar and lodged with the International Monetary Fund, member countries of the Fund undertaking to maintain their rates within specified limits (see page 522). Today, however, the practice is to measure sterling's exchange value not with reference to the U.S. dollar, but to an average of selected major currencies. Balance of payments difficulties have resulted in several countries allowing their currencies to fluctuate freely in the foreign exchange market, according to demand and supply influences.

METHODS OF TRANSFERRING FUNDS ABROAD

There are several methods of transferring funds from one financial centre to another. The principal characteristics of the most important of these are briefly described below. (It should be stated that the rates of exchange applied to the different types of credit remittance vary chiefly according to the facility they offer for obtaining payment.)

BILLS OF EXCHANGE. This term covers bills drawn on demand or at sight (*short bills*), bills at term (*long bills*), cheques and bankers' drafts.

CABLE TRANSFERS OR TELEGRAPHIC TRANSFERS. These are a most important form of remittance, but, as their use requires an elaborate system of authenticating telegrams or cables (there being no signatures to verify), they are, in practice, confined to the members (mostly banks) of the various exchange markets of the world and to the largest commercial concerns. As their name implies, they are a type of "order to pay" expressed in telegraphic form instead of in the form of a bill or cheque.

MAIL TRANSFERS. The Mail Transfer is a form of remittance designed to economise the drawing of cheques or drafts by banks on one another, and to obviate the risk that the funds may fall into wrong hands. It can be classed as a mailed form of telegraphic transfer, embodying instructions to a bank overseas to make a payment to a named payee and is used mainly between first-class institutions where the payment to the named third party can be effected by a credit to account or by a payment to another bank. Sometimes it is arranged that the instructions shall be sent by airmail, in which case the remittance is known as an *airmail transfer*.

STOCK EXCHANGE SECURITIES. Certain obligations of Governments (bonds), and of rubber, oil, mining and other industrial companies (bonds, stocks and shares), are saleable in the principal financial centres of the world, and the interest coupons are often expressed to be payable in one of several centres at the choice of the holder.

Exchange control regulations restrict the sale of stock exchange securities abroad. A considerable part of the holdings of foreign securities by British residents was compulsorily bought during the war by the Government and sold abroad to obtain foreign exchange, particularly in hard currency areas. Now, bearer securities must be deposited with a bank and transferred only to another bank, a stockbroker or a solicitor designated as an authorised depository.

FOREIGN EXCHANGE TABLE FOR MARCH 20TH, 1978

	Market rates (day's range)	Market rates (close)
New York	\$1.9000-9115	\$1.9035-9045
Montreal	\$2.1375-1505	\$2.1390-1400
Amsterdam	4.14½-17f	4.15½-16½f
Brussels	60.30-70f	60.40-50f
Copenhagen	10.65-70k	10.66½-67½k
Frankfurt	3.87½-91m	3.88½-89¼m
Lisbon	77.50-78.50e	77.95-78.45e
Madrid	151.50-152.40p	77.95-78.45e
Milan	1625-33lr	1628-29 lr
Oslo	10.13-16k	10.14-15k
Paris	8.71-84f	8.82¾-83¾f
Stockholm	8.75-82k	8.75¾-76¾k
Tokyo	437-47y	440-42y
Vienna	27.90-28sch	27.90-28.00sch
Zurich	3.62½-66½f	3.65-66f

THE FOREIGN EXCHANGE TABLE

Leading newspapers publish a Table which gives the rates (in terms of units to £1) ruling in London on the previous day. Buying and selling prices are quoted for each currency and the Table shows the day's range, *i.e.*, the highest and lowest quotations and prices ruling in the market at the close of business.

FLUCTUATIONS IN THE EXCHANGES

Fluctuations in the exchanges are caused by variations in the demand for and the supply of the currency concerned. Changes in demand and supply over a short period are influenced mainly by the following factors:

- (a) **POLITICAL FACTORS.** These include general political stability, strength of institutions and confidence in the future.
- (b) **COMMERCIAL FACTORS.** These include international indebtedness arising not only from the export and import of goods, but also in respect of various charges, *e.g.*, freight, insurance and commission, incurred in respect of the movement of goods and of the tourist industry.
- (c) **FINANCIAL FACTORS.** These include movement of bankers' funds from one centre to another for short periods to take advantage of higher interest rates (*i.e.*, *hot money* that is liable to sudden withdrawal); the sale and purchase of stock exchange securities; international borrowing and lending; and interest payments by the nationals of one country to those of another.
- (d) **SPECULATION, *i.e.***, purchases or sales of foreign currencies in expectation of a rise or fall in their values as far as any exchange control permits.

In the long run the rates of exchange are influenced by any changes in currency and credit conditions that cause variations in the price levels of the countries concerned.

ARBITRAGE OPERATIONS

Arbitrage operations in exchange are undertaken by dealers for the purpose of realising profits from differences in exchange rates ruling in two or more markets at the same time. For example, if there is a temporary divergence between the rate quoted in London for francs and the rate quoted in Paris for sterling, it might be possible to make a profit by buying francs in London and selling them in Paris. Such an operation, where only two centres are involved, is known as *simple*

arbitrage. Where three or more centres are involved in the operation, the term *compound arbitrage* is used.

METHODS OF ELIMINATING EXCHANGE RISKS

It is obvious that a person who has to pay or receive at some future date a debt expressed in foreign currency may be involved in considerable loss if the rate of exchange moves against him in the meantime. There are in general three methods by which risks of loss through exchange fluctuations may be avoided, namely (a) the purchase or sale of *forward exchange*, (b) the use of *exchange clauses*, and (c) the opening of *foreign currency accounts*.

FORWARD EXCHANGE

The system of forward exchange is an application of the principle of "futures" to dealings in foreign exchange. A rate is fixed at once at which the foreign currency is to be sold at a future date, but no money passes until the contract matures. For example, a merchant in this country who has bought from America goods for which he will have to pay at the expiration of three months, can arrange for his banker to secure for him dollars for "forward" delivery. Similarly, an English exporter, who has received payment by a bill in foreign currency due in three months' time, can at once sell the currency "forward" to his banker at a fixed rate.

Forward rates are quoted at a *premium* or *discount* in relation to the *spot* rate, which is the rate for immediate delivery. If forward rates are at a premium, it means that forward currency is dearer than spot currency. Thus, if the spot rate for dollars is \$2·80 to the £, the forward rate might be \$2·79 (a premium of 1 c.). Conversely, if forward rates are at a discount, it means that forward currency is cheaper than spot, so that with a spot rate as above, the forward rate might be \$2·81 (a discount of 1 c.).

EXCHANGE CLAUSES

An exporter who invoices his goods to the importer in his own currency avoids the risk of exchange fluctuations; but if it is agreed that he is to obtain payment by drawing a bill in his own currency it will be necessary to include in the bill a clause indicating the rate of exchange at which it is to be paid by the drawee. The following are the principal exchange clauses used by exporters from Britain:

- (a) *Payable at the collecting Bank's Selling Rate for Sight Drafts on London on Day of Payment*. This clause requires the drawee to

pay sufficient foreign currency to the collecting banker to enable the latter to issue a sight draft for the face amount of the bill.

- (b) *Payable without Loss in Exchange.* This clause has practically the same effect as (a), but the collecting bank is compelled to accept *any* banker's draft on London for the face amount of the bill, and may therefore lose the profit which he gains under (a) on the sale of his own draft.
- (c) *Exchange as per Endorsement.* This clause is used only in sterling bills drawn in this country, and can be inserted only by agreement between drawer and drawee. The banker negotiating a bill in which this clause is included converts the bill into foreign currency at a rate adjusted to the term of the bill, and can therefore pay over the face amount to the drawer without any deduction for discount or other charges. The rate is endorsed on the bill by the banker, who also alters the sterling amount of the instrument into its foreign currency equivalent at the adjusted rate, so that the foreign drawee will know what he has to pay.

FOREIGN CURRENCY ACCOUNTS

These accounts, maintained by a business with its bank, are ordinary banking accounts in which receipts on behalf of the customer are credited and disbursements are debited. Losses that would arise from the sale to the bank at current rates of the currency received and purchase of currency required from time to time are not, strictly speaking, eliminated by this method of dealing, because eventually a day of reckoning must come. But it is possible for a customer who has future commitments in a foreign currency to buy that currency now, subject to exchange control requirements, and leave it on his currency account pending settlement of the debt concerned.

EXCHANGE STABILISATION ACCOUNTS

On the breakdown of the international gold standard in 1931, direct Government regulation in the field of currency and exchange became increasingly necessary. Various governments instituted measures for protecting their countries against the harmful effects of exchange fluctuations.

The *Exchange Equalisation Account* was set up in 1932, with the object of providing the Treasury with funds to eliminate short-term fluctuations in the value of sterling. If the control wishes to prevent a rise in the value of sterling it buys foreign currencies (*e.g.*, francs and

dollars) or, alternatively, it might buy gold in foreign centres. To prevent a fall in the value of sterling the control might sell some of its holdings of gold or foreign currencies.

On the outbreak of the war in September, 1939, the bulk of the Bank of England's gold holding was transferred to the Exchange Stabilisation Account, which has continued to hold virtually the entire gold stock of the country ever since.

The present function of the Account is much wider than that of ironing out short-term fluctuations. It is part of the Exchange Control system and is used to regulate the important exchanges and assist in maintaining the rates at a level consistent with Government requirements.

EXCHANGE RESTRICTIONS AND CONTROL

Amongst the devices used for controlling exchanges the following may be mentioned:

1. EXCHANGE PEGGING, *i.e.*, maintaining the exchange-value of the currency at a certain level by official purchases and sales.
2. EXCHANGE RESTRICTIONS. These range from the mild form of prohibition of speculative dealings to an extreme form in which no transaction in foreign currency is allowed without an official permit. In some cases all transactions have to be passed through an official institution; in others, the controlling authority actually fixes an "official" rate at which all transactions must be made.
3. BLOCKED CURRENCY. Certain countries have adopted a system whereby if a sum in the home currency is due to a foreign creditor, *i.e.*, an exporter, it is merely credited to him in a *special account*—a "blocked" account—which can be drawn upon by him only for certain stipulated purposes, *e.g.*, for the purchase of goods in the home country.
4. EXCHANGE CLEARINGS. The growth of exchange restrictions so hampered trade between some countries that they were led to enter into "Exchange Clearing" agreements to mitigate the harm done to their foreign trade.

Under such agreements all exchange dealings between the countries concerned pass through central authorities (usually the central bank of each country) by whom receipts are offset against payments, and exchange dealings by private traders are obviated.

INSURING THE TRANSFER RISK

The possibility that an exporter may be unable to obtain payment from abroad owing to the imposition of some restriction on the trans-

fer of the funds, *e.g.*, the "blocking" of the currency, adds to the risks of exporting. It is possible, however, for an exporter to insure against this risk.

The Export Credits Guarantee Department is willing to insure the "transfer-risk" for any exporters who insure the whole of their credit risk under the Department's Comprehensive Guarantee.

INTERNATIONAL EXCHANGE

It was clear after the war that the gold standard could not be restored and that other means of settling international indebtedness would have to be found. At Bretton Woods, U.S.A., agreements were formulated in 1944 by the United Nations to provide the necessary framework. The basis of the proposed structure was to be a relatively fixed exchange rate system and an international system for supplementing existing national monetary resources. It was recognised that creditor countries as well as debtors were under an obligation to restore and maintain balance of payments equilibrium and that multilateral trade and free currency convertibility were indispensable. It was agreed that to achieve international monetary co-operation a permanent body should be set up and non-monetary agencies used to correct employment and trade disturbances. An international investment bank was also considered necessary.

These were the principles behind the International Monetary Fund (I.M.F.) and the International Bank for Reconstruction and Development, *i.e.*, the World Bank. Both institutions began operating in 1947. In 1977, the I.M.F. had 131 members.

INTERNATIONAL MONETARY FUND. A fund was set up composed of gold and the currencies of the member nations, so that members could obtain from the Fund, in exchange for their own currencies, restricted amounts of such foreign currencies as they needed to meet legitimate trade balances. The size of the Fund was initially fixed at 8,800 million U.S. dollars, subscribed by members in accordance with a schedule of quotas, each member being required to pay its quota partly in gold or U.S. dollars, and partly in its own currency. On several occasions the quotas have been increased.

The size of each member's quota determines: (1) its contribution to the Fund; (2) the amount of foreign exchange it can acquire from the Fund; and (3) its voting power as regards the administration of the Fund.

The *Par Value* of each member's currency was declared in the autumn of 1946. Members were required to maintain the agreed parities within a range of 1 per cent on either side; the band of 2 per

cent has since been extended to 4.5 per cent, following the Smithsonian Agreement of 1971. See the *International Monetary Fund Act* 1979.

Purchasing Rights. Each member may in any twelve months purchase from the Fund in exchange for an equivalent amount of its own currency foreign exchange not exceeding 25 per cent of its own quota, but 200 per cent of a member's quota is the maximum amount of any member's currency that the Fund may hold at one time. It would, therefore, take a debtor country four years to exhaust its excess drawing rights.

Continued drawing on the Fund by one State indicates that such a State is importing too much relative to its exports, and also that another State (or States) is importing too little relative to its exports. To adjust the situation international action is necessary. The Fund has no power to compel creditor nations to accept *goods* in payment for exports, but, if excessive exporting continued, the Fund would eventually be faced with a shortage of the currency of the exporting State. The Fund in such circumstances can (1) inform members of the situation and investigate the causes; and (2) propose that the exporting member lend its currency to the Fund, or, alternatively, arrange to buy the scarce currency from the exporting State for gold. If these or other measures fail, the Fund can declare the member's currency "scarce" and ration its supply according to the needs of other members. Members may introduce control over their foreign exchange operations relating to scarce currencies.

Special Drawing Rights. A major post-war problem has been the shortage of foreign exchange resources with which to finance the growing volume of international trade. The production of gold has not kept pace with the monetary demand for it while the industrial demand has been rising steadily. The increases in the quotas of members of the International Monetary Fund have failed to solve the problem while the growing dependence on the U.S. dollar and the pound sterling as the main reserve currencies put undue pressure on those currencies.

In July 1969 a new form of credit was created—Special Drawing Rights—whereby members of the Fund can settle debts between themselves by drafts on a fund created by the Fund. The allocation of these rights was based on members' quotas with the Fund.

In January, 1976, the I.M.F.'s Interim Committee reached agreement on a number of recommendations concerning a revision of the Fund's Articles of Agreement. Provision is now made for a likely return to a par value system, but, in the meantime, members are permitted to operate individual exchange arrangement under the general supervision of I.M.F. The status of gold is reduced by the

abolition of the official gold price. The gold holdings of the Fund are to be gradually reduced. One-sixth of the holdings will be returned to members and one-sixth will be auctioned, the proceeds to be used so as to finance a trust fund which will assist the poorest of the developing countries.

I.M.F. is controlled by a Board of Governors on which all members are represented. In practice a smaller Executive Board of 20 members controls the Fund's activities. The Executive Board comprises 5 appointed directors nominated by the 5 members with the largest quotas—France, Japan, U.K., U.S.A. and Germany—and elected directors nominated by groups of member states. The Fund's managing director is appointed by the Executive Board; he acts also as chief of the international staff. The Board of Governors meets only once a year; except for matters such as quota changes and admission of new members, most of its powers have been delegated to the Executive Board.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

The function of the Bank is to assist and encourage long-term international investment through established channels by participating in the development of productive enterprises which could not otherwise be financed on reasonable terms. This is done mainly (1) by guaranteeing private investment abroad; (2) by direct lending; and (3) by participation, with private investors, in foreign lending.

The Bank is not intended to finance schemes that do not constitute a reasonable business risk, or grant loans which can be obtained in the private capital market on reasonable terms. The Bank's advances other than to Governments (*e.g.*, to local government or commercial undertakings) can be made only if the borrower's Government guarantees payment of interest and repayment of capital.

Since its inception the Bank has made 1,452 loans totalling 38,610,400,000 U.S. dollars.

EXCHANGE CONTROL IN BRITAIN

In Britain, all foreign exchange acquired by the general public has to be surrendered to an authorised dealer against payment in sterling. The commercial banks act for the Treasury and the Bank of England in carrying out the routine work of exchange control. The aim of exchange control policy is the general regulation of the manner in which investment outside the Scheduled Territories (see below) is financed. As a result official exchange is made available only for those projects which appear to confer a continuing benefit to the U.K.'s balance of payments.

Exchange Control Act 1947: By this Act:

- (1) Dealings in gold and foreign exchange are restricted to authorised dealers (mainly banks) to whom all gold and foreign exchange must be sold. The dealers are in turn obliged to sell to and buy from the Exchange Equalisation Account, but are allowed a certain latitude in "marrying" daily transactions. By this canalisation of supply and demand, official rates are maintained and a central supply of exchange is assured.
- (2) Payments to persons outside the Sterling Area (see below) require Treasury permission, though most classes of business may be handled by the banks with minimum formality.
- (3) Strict control is exercised over (a) the issue and transfer of securities involving non-residents; (b) foreign securities and bearer shares (which must be lodged with a bank or other approved depositary); and (c) the import and export of notes and coins.
- (4) Obligations are imposed on exporters to ensure the prompt remittance to Britain of foreign exchange arising from exports. In practice, payment for goods exported should be received in foreign currency (or in sterling from a non-resident source) usually within six months of export unless the goods are covered by an approved export credit arrangement.

The *Sterling Area* (referred to in the Act as the "Scheduled Territories") now consists of the United Kingdom, the Isle of Man, the Channel Islands, the Irish Republic and Gibraltar.

E.E.C. AND CURRENCY STABILISATION

The concept of a single currency for the nine E.E.C. Member States (Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, U.K.) has found expression in a number of policy declarations of E.E.C. leaders. Moves towards the realisation of that concept have found expression in a drive towards currency stabilisation within the Community. Thus, attempts were made in the early 1970s to stabilise currencies in terms of exchange rates within a band of 2.25 per cent. The phrase "snake in the tunnel" was used to refer to the E.E.C. currencies contained within this band ("the snake") moving within the broader I.M.F. band ("the tunnel"). The arrangement became ineffective after April, 1973. Monetary union of E.E.C. states remains fundamental Community policy; at the centre of plans for such a union would be the European Monetary Co-operation Fund.

The European unit of account (E.U.C.), which is now used in most areas of Community activity, except the common agricultural

policy and the operations of the Monetary Co-operation Fund, is designed to reflect day-to-day fluctuations on foreign exchange markets. It is a "basket" unit of account made up from a number of different national currencies. Thus, in May, 1978, the value of one E.U.C. was the sum of the values of: 3.66 Belgian francs, 0.14 Luxembourg francs, 0.828 German marks, 0.286 Dutch guilder, 0.0885 £ sterling, 0.217 Danish krone, 1.15 French francs, 109 Italian lire and 0.00759 Irish pounds. The value of the E.U.C. in a national currency will move in line with a weighted average of exchange rates in all the currencies in the "basket", that is, it will mirror the aggregate movement in those currencies. The value of the E.U.C. in the currencies of Member States will be determined daily by the Commission of the E.E.C. on the basis of official rates notified by the central banks of those states. Rates for the value of the E.U.C. in various national currencies are published daily in the *Official Journal of the European Communities*.

EUROCURRENCY

The significance of dealings in the Eurocurrency markets was outlined in Chapter 38. Depositors of Eurocurrency with London banks may earn a special rate of interest known as LIBOR (*London Inter-bank Offered Rate*). The banks lend these deposits at 1–2 per cent above the rate paid to their depositors. There has been some criticism of these dealings as a source of intensified speculation on the foreign exchange markets. It has been suggested, however, that, since the Eurocurrency market is relatively free from control and, therefore, approximates to the conditions of a free market reflecting the true nature of demand and supply, it performs a useful function by giving indications of the *real value* of currencies in terms of one another—indications that may be more accurate than those given by the rates published by controlled foreign exchange markets.

INDEX

- At Lloyd's 359
- Abandonment 260
- Absorption 167
- Acceptance Credits 486
- Accepting Houses 494
- Accident Insurance 259, 277-9
 - Types of Policy 277-9
- Accordion Theory of Retailing 299
- Account
 - Allotment Money 473
 - Banking 467-8
 - Budget 321
 - By Cheque, payment of 108, 446-7
 - Call Money 473
 - Charge 321
 - Current 379, 381, 462, 468
 - Day 510
 - Deposit 462, 468
 - DX 474
 - Exchange Stabilisation 520-1
 - Foreign Stabilisation 520-1
 - Foreign Currency 519, 520
 - Investment 475
 - Loan 468, 479
 - Sales 416
 - Savings 474
 - Types of Bank 468
- Accountant 74
- Accounting
 - Financial 130, 148-85
 - Management 130-85
 - Ratios 132, 170-7
- Accounts
 - Company 44-6
 - Filing of 37
- Active Partner 14
- Acts of Bankruptcy 224-5
- Actual Total Loss 270
- Adding Calculators, Non-Listing 84
- Adding-Listing Machines 84
- Addressing Machines 84
- Address
 - of Company 36
 - Postal 365
- Adjudication Order in Bankruptcy 229
- Adjustable Fire Policies 276
- Adjustment, Average 272
- Administrative Cost Budget 140
- Ad Valorem* 356, 400
- Advance Payment of Corporation Tax
 - (A.C.T.) 217
- Advances by Banks 482-5
- Advances, Security for 479-82
- Advantage, Comparative 375
- Advertising 118 *et seq.*
 - Agency 120-1
 - Benefits and Disadvantages of 121-2
 - Campaign 118-19, 121-2
 - Definition of 118
 - Manager 73
 - Media 119-20
 - Objectives of 118-19
 - Point-of-Sale 120
 - Wholesale 312-13
- Advice
 - Note, Agent's 392, 402
 - of Shipment 392-3, 407
 - to Customers 104
- Advisory, Conciliation and Arbitration Service
 - (A.C.A.S.) 202
- After-Sales Service 340
- Agency
 - Advertising 120-1
 - Credit Inquiry 254
 - Services of Banks 462
- Agent
 - Air Freight 402
 - Commission 249
 - Del Credere* 250
 - Export 384, 385
 - Export Commission 384-5
 - Lloyds 262
 - Packing, Shipping and Forwarding 385
- Agent's Advice Note 402
- Agents' Marks 385-6
- Agricultural
 - Charge 485
 - Credit 485
- Agricultural Credits Act* (1928) 485
- Agricultural Mortgage Corporation, Ltd 478, 485, 497
- Air
 - Carriage by 360, 402-4
 - Consignment Note 402-4
 - Freight Agent 402
 - Freight Rates and Fares 362
 - Mail 367-8
 - Mail Transfers (A.M.T.) 429, 517
 - Transport 360-2
 - Waybill 402
- Airports 362
- Airway Letters 366
- Allotment 31-2, 506
 - Letter 31, 164
 - Moneys Account 473
- Allowances, Capital 215

- All Risks Insurance 278
- All-Up Service 367-8
- Amalgamation 165-70
 - Horizontal and Vertical 165
- Annual General Meetings 43
- Annual Return of Company 36-7
- Annuity 282
 - Deferred 282
 - Method and Goodwill 181-2
- Anti-Dated Cheques 442
- Appropriation Acts* 208
- Arbitrage 518-19
 - Compound 519
 - Operations 253, 518-19
 - Simple 518
- Arbitrageurs 253
- Arbitration 261
- Arrangement
 - Deeds of 228
 - Scheme of 228
- Articles
 - of Association 24, 28-9, 42-3, 44, 157
 - of Partnership 19
- Articles Prohibited by Post 365
- Assets
 - Current 172, 173
 - Distribution in Bankruptcy 231-2
 - Fixed 148
 - Liquid 151
- Assignment 481
 - of Assurance Policy 281
 - of Insurance Policy 269
- Association
 - Articles of 28-9
 - Clause 25
 - Memorandum of 15, 24 *et seq.*, 28
- Associations
 - Combinations and 50-9
 - Export 385, 386
 - Protection and Indemnity 273
- Assurance 258, 279-82
 - Endowment 279
 - Life 259, 279-82
 - Policy, Assignment of 269
 - Whole Life 279
- Atomic Energy 63
 - Research Establishment 63
- At Station 101
- Attorney, Power of 507
- Auctions 242-3
- Audit
 - Company 45
 - Continuous 127
 - of Efficiency 66
- Auditors 30, 45-6
- Authorised Capital 158
- Authorised Clerks 503
- Authority, Principle of 69
- Automated Warehouse 311
- Automatic Discharge of Bankrupt 233
- Automatic Vending Machines 330
- Average 270-2
 - Adjustment 272
 - Collection Period 174
 - General 270, 397
 - Particular 270-1, 397
 - Subject to 275
- Back Freight 357
- Backwardation 510, 512
- Bad Debts Insurance 254, 278-9
- Balance of Payments 379-80
- Balance of Trade 379
- Balance, Principle of 69
- Balance Sheet, Bank 464-7
- Balancing Item 381
- Bank
 - Account 467-9
 - Advantages of 467-8
 - Closing of 472
 - Opening of 468
 - as Provider of Credit 477-9
 - Central 453
 - Clearings 463-4
 - for International Settlements 455
 - Giro 109
 - National Savings 474-5
 - Loans, Types of 478-9
 - Notes 421
 - Convertible 421
 - Inconvertible 421
 - Overdraft 478
 - Post Office Savings 474-5
 - Premises 467
 - Rate 457
 - Reconciliation Statement 469-70
 - Standing Orders 472-3
 - Statement, Customer's 468, 472
 - World 455, 522, 524
- Bank Charter Act (1844)* 454
- Banker
 - Customer and 470-1, 472-4
 - Duties of 447-8
 - Negligence of 451
 - Protection of 450-1
 - Secrecy and 470-1
 - Services of 472-4
- Bankers'
 - Automated Clearing Services 464
 - Discount 440
 - Drafts 429
 - Lien 471
 - Opinions 471
- Banking
 - Account 467-8
 - Branch 461-2
 - Central 453
 - Finance of Trade and 474, 476-89
 - Lending Policy and 482-8
 - Mergers 461
 - Partnerships 15
 - Remittances 427-30

- Settlement of Indebtedness 476-7
- System 453-75
- Bank of England 453-60, 490
- Banking Department 454, 459
- Control of Money Market 490, 494
- Court of Directors 454
- Creation and Development of 453-4
- Functions of 454-6
- Issue Department 454, 459
- Monetary Policy and 456-9
- Organisation of 454
- Weekly Return 459-60
- Bank of England Act* (1946) 458
- Bankruptcy 197, 223-34
 - Acts of 224-5
 - Adjudication Order in 229
 - Composition and 228
 - Criminal 232
 - Distribution of Assets 231-32
 - Examination 227
 - Notice 225
 - Offence 232
 - Partner, of 17, 20
 - Partnership, of 20
 - Petition 225-6
 - Proof of Debts in 230-1
 - Proper Court of 226
 - Receiving Order 226-7
 - Scheme of Arrangement and 228
 - Statement of Affairs in 227
 - Trustee in 230
 - Winding Up and 234
- Bankruptcy Acts* (1914 and 1926) 223 *et seq.*
- Bankruptcy Rules* (1952) 224
- Bankrupt, Discharge of 232-4 (see Discharge of Bankrupt)
- Barter 419
- Bearer Securities 38, 41, 480, 507
- Bears 252, 511
- Bids, Take-Over 168-9
- Big Four, in Banking 168, 461
- Bill
 - Broker 491-2
 - Collection of 477
 - Discounting
 - by Banks 476-7, 479
 - Grading of 491
 - of Lading 393-6
 - Claused 395
 - Clean 394
 - Forms of 395-6
 - Foul 395
 - of Sight 410
 - of Store 415
 - Shipping 414
 - Treasury 457, 458, 490, 491, 494
- Bill of Exchange 428-9, 431-41, 516
 - Acceptance of 428, 437
 - Acceptor 433, 435
 - Alteration of 437, 438
 - and Promissory Notes 441
 - Bearer 434
 - Cancellation 438
 - Conditional Acceptance of 438
 - Date of 432
 - Definition of 428
 - Delivery of 434
 - Demand, On 429
 - Discharge of 438
 - Discounting of 429, 439-40, 462, 476-7
 - Dishonour of 438-9
 - Drawee 433
 - Drawer 433, 435
 - Due Date of 433
 - Endorsements 436-7 (see Endorsement, Bills of)
 - Endorser 433, 435
 - Holder 434-5
 - Inland and Foreign 431, 432
 - Liabilities on 435
 - Negotiation of 429, 436-7, 476-7
 - Overdue 437
 - Partial Acceptance of 438
 - Parties to 433-4
 - Payee 433
 - Policy 279
 - Qualified Acceptance of 438
 - Requisites of Valid 431-2
 - Sight 429
 - Signature to 434
 - Specimens of 431, 432
 - Transferor by Delivery 435-6
- Bills of Exchange Act* (1882) 198, 431 *et seq.*, 453
- Binary System 91
- Bits 91, 370
- Blank Cheques 445
- Blocked Currency 521
- Board of Inland Revenue 216
- Board of Referees 216
- Bond 412, 414
 - Bearer 41
 - General 414
 - In 389
 - Note 414
- Bonded Store Houses 412
- Bonus Issues 39, 163-4
- Bought and Sold Notes 104
- Box Files 80
- Branch Banking 461-2
- Branded Goods 50-1, 303, 312-13
- Break-Even
 - Analysis 130-6
 - Charts 134-6
 - Point 130, 131-2
- Bretton Woods Agreement 522
- British Airways 361-2
 - Associated Companies, Ltd 361
 - Engine Overhaul, Ltd 361
 - European 361
 - Helicopters, Ltd 361
 - Services 361
- British Employers' Confederation 207

- British Gas Corporation 61
- British Hovercraft, Ltd 351
- British National Oil Corporation 63-4
- British Overseas Airways Corporation 361
- British Rail 56-7, 350-4
 - Engineering, Ltd 351
 - Network 351
 - Passenger Services 351
 - Regional Operations 353-4
 - Shipping and International Services Division 351
- British Steel Corporation 62
- British Transport Hotels, Ltd 351
- Broker 523
 - Bill 491-2
 - Government 502
 - Marine Insurance 262
 - Produce 249
 - Running 491
- Budget
 - Accounts 321
 - Administrative Cost 140
 - Adoption of 143-4
 - Capital Expenditure 140
 - Cash 140-2
 - Centres 137
 - Deficit 208
 - Definition of 136-7
 - Distribution Cost 140
 - Finished Stock 139
 - Flexible 146
 - Master 137, 142-3
 - Periods 137-8
 - Plant Utilisation 139
 - Production 139
 - Programme 145-6
 - Report 144-5
 - Research and Development 139-40
 - Sales 138-9
 - Selling Cost 140
 - Subsidiary 138-42
 - Surplus 208
 - Variances and 144
- Budgetary Control 136-47
 - Definition of 136-7
 - Objectives of 137
- Budgeted Trading and Profit and Loss Account 143
- Builders' Risk Policies 266
- Bulk Goods, Landing of 412
- Bulk Purchases 55
- Bulls 252, 253, 504, 511
- Burglary, Insurance against 278
- Business
 - Capital Requirements of 29-30
 - Certificate to Commence 32-3, 505
 - Intermediaries and Risk Bearers 247-57
 - Names, Registration of 18, 19
 - Occupations 8
 - Reply Service 364
 - Unit, Size of 9-10, 50, 55
- Buyer
 - Chief 73
 - Commission 249, 251
- Buying
 - Centralised 318, 336
 - Department 99
 - Direct 248
 - Impulse 335
 - Offices, Importers' 385, 386
 - Plan 336
 - Retail 318, 335-6
 - Selling and 99-109
- Cable Transfers 516
- Caging 302
- Calculators, Electronic 84
- Calculating Machines 84
- Call Money Account 473
- Call Option 512
- Canal Transport 355
- Capacity to Contract 191
- Capital
 - Allowances 215
 - Authorised 158
 - Circulating 148-9
 - Employed 171-2, 174
 - Expenditure Budget 140
 - Fixed 148
 - Floating 148-9
 - Gains Tax 217-18
 - Gains Tax Act* (1979) 217
 - Gearing 159-60
 - Interest Cover and 156-7
 - Issued 158
 - Issues 473
 - Liquid 150-1
 - Market 478, 496-513
 - Inner 496
 - Outer 496-7
 - Memorandum of Association and 24-5
 - Nominal 28
 - Obtaining of, by Company 29-30, 34, 157-8
 - Public Dividend 65
 - Reduction of 36
 - Requirements of a Business 148, 160-1
 - Structure 158-60
 - Working 148, 149-50
- Capitalisation
 - Goodwill, Basis of 180
 - Over- 56, 153
 - Under- 153
- Captain's Protest 399
- Cards, Post 363
- Cargo
 - Air, by 360, 402-4
 - Capacity 358
 - Jettisoning of 397
 - Policies 269
 - Ships, Types of 356

- Carriage
 - Forward 102
 - Paid 101, 102
- Carriage by Air and Road Act* (1979) 404
- Carriage of Goods by Sea Act* (1924) 395
- Cartels 52, 248
- Cash
 - and Carry Warehouses 115, 306, 317
 - Book Balance 469, 470
 - Budget 140-2
 - Discount 103
 - Forecast 151-2
 - Net 102-3
 - on Delivery (C.O.D.) 102, 366-7, 389, 427
 - Prompt 102
 - Spot 102
 - with Order (C.W.O.) 102, 389
- Catchment Area 332
- Caveat Emptor* 340
- Cellular Ships 356
- Central Arbitration Committee 202
- Central Banks 453
- Central Electricity Generating Board 63
- Central Electricity Research Laboratories 63
- Centralisation 71
- Centralised Buying 318, 336
- Certificate
 - of Deposit (C.D.) 492-3
 - of Incorporation 29, 505
 - of Indemnity 412
 - of Insurance 267
 - of Origin 399
 - of Posting 367
 - of Survey 399
 - Over-Entry 410
 - Shares 35
 - to Commence Business 32-3, 505
 - Trading 32
- Certification Officer 202
- Certified Account Sales 399
- Channels of Distribution 290-3
 - Activities in 291-2
 - Definition of 290
 - Design of 292-3
 - Functions of 292
 - Stages of 290-1
- Charge
 - Accounts 321
 - Agricultural 485
 - Fixed and Floating 39, 481
 - Trade 427
- Charter
 - Time 356, 396
 - Voyage 356, 396
- Charter Party 396
- Check-Out Points 335
- Cheque 427, 442-52
 - Alteration of 445
 - Ante-Dated 442
 - Banker's Duty to Pay 447
 - Blank 445
 - Book 468
 - Card 474, 489
 - Circular 489
 - Countermand of Payment 448-9
 - Crossed 446
 - Crossing 443-5
 - General 427, 443
 - Not Negotiable 443
 - Not Transferable 443, 444, 446
 - Opening of 444-5
 - Special 427, 443, 444
 - Definition of 442
 - Endorsement, Rules of 451-2
 - Forgery of 449
 - Guarantee Cards 430
 - Marking 450
 - Open 444
 - Paying Accounts by 108, 446-7
 - Postal 430
 - remittance of 430, 445-6
 - Post-Dated 442
 - Recognition 97
 - Stale 442
 - Theft of 448
 - Travellers' 489
- Cheques Act* (1957) 108, 450
- Chief Buyer 73
- Cinema in advertising 119
- Circular
 - Cheques 489
 - Letters of Credit 488
 - Notes 489
- Circulating and Working Capital 148-9
- City Code on Take-Overs and Mergers 169
- City Link Transport Services, Ltd 352
- Civil Aviation Authority 362
- Civil Employment 8
- Clean Credit 486
- Clearing, Banks'
 - General 463, 464
 - House 463-4
 - Local 463
 - System 463-4
 - Town 463
- Clearing House, London 463-4
- Clearing Houses, Produce 243
- Clearings, Exchange 521
- Clear-View Plan 334
- Closed Shop 203
- Closing Slip 263-4
- Coal Board, National 57, 61-2
- Coal Nationalisation Act* (1946) 61
- Coal Research Establishment 62
- Coinage 421
- Coin, Definition of 421
- Collateral Security 481-2
- Collection and Delivery Parcels Service 352
- Collection of Bills 428, 477
- Collective Agreements 205
- Collective Bargaining 205
- Collectors of Taxes 216

- Combinations 50-9, 248
 - Advantages of 54
 - Associations and 50-9
 - Efficiency of 55-6
 - Forms of 51 *et seq.*
- Commercial
 - Banks 463-74
 - Balance Sheet 464-7
 - Functions of 462-3
 - Credits 486
 - Occupations 4, 5
 - Radio 119
 - Structure and Organisation 3-185
 - Undertakings, Types of 9-67
- Commission
 - Agents 249-50
 - Bankers' 471
 - Buyers 249, 251
 - Exporters 384-5
 - Salesmen 249, 250-1
 - Underwriting 501
- Commissioners
 - General and Special 216
 - of Inland Revenue 216
- Committee of London Clearing Bankers 463
- Committee, Cost of hiring Advisory 422
- Commodity
 - Information Retrieval 97
 - Markets 239, 241-6
 - Cotton 244
 - Diamonds 245-6
 - Grain 243-4
 - Metals 246
 - Rubber 246
 - Tea 244-5
 - Wool 245
 - Taxes 210
- Common Carriers 353
- Common Market 416
- Communication
 - Satellites 371
 - Systems of 347-72
 - Transport and 347-62
- Companies 23-49
 - Accounts 44-6
 - Address of 36
 - Annual Return 36-7
 - Audit 45
 - Charter, Royal 23
 - Credit Factoring 254
 - Credit Insurance 254, 405
 - Defined 23
 - Development of 23
 - Directors 42-3
 - Dissolution by Court Order 48
 - Equity of 34, 502
 - Exempt Private 37
 - Finance 500
 - Goodwill, Valuation of 182-5
 - Holding 51-2, 166
 - Legislation 23
 - Limited 11, 12, 23, 28
 - Advantages and Disadvantages of 48-9
 - Management of 42-3
 - Marine Insurance of 263
 - Meetings of 43-4
 - Membership of 35-6
 - Obtaining Capital 29-30
 - Office, Registered 25
 - Parliamentary 23
 - Private 12, 24, 37, 46-7
 - Promoters 500-1
 - Prospectus 30
 - Public 12, 24, 30
 - Reconstruction of, 167-8
 - Registered and Partnership 22
 - Registers, Statutory 46
 - Registrar of 11
 - Registration of 29
 - Shares in 33
 - Statutory 23
 - Striking off 48
 - Termination of 47
 - Unlimited 23-4
 - Voluntary Liquidation 47
 - Winding-up 47-8
 - Companies Acts* (1948, 1967, 1976) 15, 19, 23 *et seq.*, 162, 223, 506
 - Comparative Costs, Law of 375
 - Compensation Fee, Parcel 364
 - Competition, E.E.C. Attitude to 58-9, 383
 - Competitive Economy 58, 60
 - Composite Policies 266
 - Composition and Bankruptcy 228
 - Computer 89-98, 311, 315, 371
 - Applications of 94-8
 - Cheque Recognition and 97
 - Commodity Information Retrieval and 97
 - Control Devices of 92
 - Control of Wages by 94
 - Credit Control and 97
 - Definition of 89
 - Execution of Orders by 311
 - Functions 89-90, 91
 - Future Development of 98
 - In Commerce 89-98, 295, 311, 315
 - Input to 90
 - Invoicing 94
 - Languages 93
 - Logic 92
 - Operational Research and 96-7
 - Output of 92-3
 - Processing Devices of 92
 - Programming of 93
 - Site Choice and 97
 - Stock Inventory and 95-6
 - Storage in 90-2
 - Concept Research 127
 - Condition 340
 - Conditional Discharge 233
 - Confederation of British Industry 207, 422

- Conference System, Shipping Rates 357
- Confirmed Credits 486
- Confravision 370
- Consequential Loss Insurance 277
- Consideration and Contract 189-90
- Consignment, Goods on 406-7
- Consignments, Split 411-12
- Consignor 403
- Consignee 403
- Consolidated Fund 208
- Consortium 165
- Constructive Total Loss 270
- Consular Invoices 400
- Consumer Credit Act* (1974) 340, 341, 342
- Consumer Credit Business 341
- Consumer Legislation 340-4
- Consumer Promotions 117
- Consumer Protection Advisory Committee 341
- Consumers
 - Final 289
 - Intermediate 289
 - Services to 4
- Container Trains 350
- Contango Day 509
- Continuity, Principle of 69
- Continuous Audit 127
- Contract 186-99
 - Defined 186
 - Employment, of 201-2
 - Forms of 186-7
 - Sale, of 340-1
- Contracts of Employment Act* (1972) 201
- Contribution 131, 136, 261, 271
 - Clause 261
- Controllable Costs 137
- Convenience Goods 338
- Convertible Loan Stock 41
- Convertible Notes 421
- Co-operative
 - Agricultural Societies 12
 - Bank 12
 - Buying Associations, Retailers' 248
 - Consumers 248
 - Credit Societies 12
 - Development Society 12
 - Dividends 323
 - Farmers 248
 - Housing Societies 12
 - Insurance Society 12
 - Movement, Structure of 325
 - Retailers 248, 323
 - Societies 12
 - Stores 323-4
 - Advantages and Disadvantages of 324
 - Future of 324
 - Membership of 323
 - Trade of 323
 - Trading Philosophy 12
 - Wholesale Society (C.W.S.) 12, 294
- Co-ordination, Principle of 69
- Copiers, Thermal 83
- Copy Invoice 104
- Corners 52, 253
- Corporation Tax 216-17
- Correspondence, Principle of 69
- Cost
 - and Freight (C. & F.) 388
 - Budget Centres 137
 - Centre Reports 137
 - Comparative 376
 - Controllable 137
 - Fixed 130
 - Insurance and Freight (C.I.F.) 388
 - Insurance, Freight and Exchange (C.I.F. & E.) 388
 - Insurance, Freight and Interest (C.I.F.I.) 388
 - Insurance, Freight, Commission and Interest (C.I.F.C.I.) 388
 - of Living Index 422
 - Plus Formula 112
 - Push Inflation 424
 - Total Distribution (T.D.C.) 347
 - Uncontrollable 137
 - Variable 130
- Countermand of Cheque Payment 448-9
- Court Order for Company Dissolution 48
- Cover
 - Capital and Interest 156-7
 - Note 282-3
 - Open 264-5
 - Reinsurance 285
- Credit
 - Acceptance 486
 - Approved 104
 - Cards 489
 - Clean 486
 - Confirmed Commercial 486
 - Computer, by 97
 - Controller 74
 - Department 104
 - Documentary 486
 - Factoring Company 254
 - Fixed 487
 - Inquiry Agencies 254
 - Insurance Companies 254, 405
 - Intermediate 477-8
 - Letter of 401, 485-9
 - Circular 488
 - Limited 488
 - Traveller's 488
 - Long-Term 478, 485
 - Manager 74
 - Non-Commercial 488-9
 - Note 106
 - Omnibus 486
 - Provision of by Banks 477-9
 - Revolving 487
 - Risk 404
 - Short-term 477, 485
 - Slip, Trader's 428

Credit, cont.

- Transfer 109, 428
- Paying Accounts by 109
- Transferable and Divisible 487
- Unconfirmed 486
- Creditors
 - Postponed 232
 - Secured 232
- Creditors'
 - Liquidation 47
 - Meetings 229
- Crossed Cheques 443-5
- Cum Div. 509
- Cum Rights 509
- Cumulative Preference Shares 33, 157
- Currency 419
 - Blocked 521
 - Decimal 426
 - Devaluation of 515
 - Flows 379
 - Regulations 368
- Current Account 379, 381, 382, 462, 468
 - Balance of Trade and 380
 - Deficit on 382
- Current Assets 172, 173
- Current Liabilities 172
- Current Ratio 172
- Customary Pricing 337
- Customer, Advice to 104
- Customs and Excise 408, 415
 - Drawback 415
- Customs Consolidation Act* (1876) 408
- Customs Debenture 415
- Data Post 366
- Dated 370
- Damage, Precautions against 311
- Daybook Copy 104
- Days of Grace 283-4
- Dead Freight 397
- Dead Space 335
- Dealers 512, 514
- Dealing, Option 512
- Debenture 39-42, 157, 481
 - Customs 415
 - Definition of 39
 - Mortgage 39, 40
 - Naked 39
 - Receivers for Holders of 41-2
 - Shares, Differences between 34, 42
- Debiting, Direct 109
- Debit Note 106
- Debtor, Examination of 227
- Debtors Act* (1869) 225
- Debts
 - Ordinary 232
 - Preferential 231
 - Pre-preferential 231
 - Proof of 230-1
- De-centralisation 56-7
- Decimal Currency 426

Declaration

- Day 512
- Fire Policies 276
- Forms 266
- Origin, of 399
- Policies 266
- Solvency, of 234
- Deeds of Arrangement 228
- Deeds of Arrangement Act* (1914) 228
- Deferred
 - Annuities 282
 - Rebates 357
 - Shares 33
- Definition, Principle of 69
- Deflation 424
- Del Credere* Agents 250
- Delivered or Free Docks 388
- Delivery 388, 434
 - Order 410-11, 413
 - Recorded 367
 - Special 366
- Demand
 - Nature of 9-10
 - Pull Inflation 424
- Demurrage 396
- Department Stores 320-3, 335
 - Advantages and Disadvantages of 321
 - Definition of 320
 - Growth of 320-1
 - Organisation of 322
 - Origin of 320
 - Trading 321
- Departmental Orders 104
- Deposit Account 462, 468
- Deposit Receipt 283
- Deposits, Special 458
- Depreciation 139
- Desk Research 127
- Despatch Department 314
- Despatch Money 396
- Devaluation 515, 516
- Development Area 332
- Deviation 268-9
 - Cause 268
 - from Vessel's Route 269
- Dictating Machines 78
- Dictation of Letters 78
- Direct
 - Buying 248
 - Debiting 109
 - Export 386
 - Mail 120
 - Selling 248, 303
 - Taxation 210
 - Transfer Accounts (DX) 474
- Directives, Special 458-9
- Director
 - Company 42-3
 - General of Fair Trading 57, 58, 341
 - Manager and 69-70
 - Shares, Interest in 46

- Directorates, Interlocking 51
- Directors, Register of 46
- Discharge of Bill of Exchange 438
- Discharge of Bankrupt 232-4
 - Automatic 233
 - Conditional 233
 - Intermediate 233
 - Suspensive 233
 - Types of 233-4
- Discharge of Bill of Exchange 438
- Discount
 - Bills of Exchange 429, 439-40, 462, 476-7
 - Bankers' 440
 - Calculation of 439-40
 - Cash 103
 - Market 491-2
 - Shares at a 35
 - Trade 103, 113
 - True 439
- Discount Stores 329-30
 - Advantages and Disadvantages of 330
 - Characteristics of 329
 - Development of 329
- Dishonour of Bill of Exchange 438-9
- Disinflation 425
- Dismissal 204
 - Constructive 204
 - Employee, of 204
 - Unfair 204
- Dissolution
 - Order for 48
 - Partnership, of 19-21
- Distribution 289-344
 - Channels of 115, 290-3
 - Cost Budget 140
 - Occupational 7-8
 - of Assets 231-2
 - Physical 295, 298
 - Sales Force and 115
 - Theories of Change in 298-9
- Distributive Trades 289-344
 - Functions of 289-90
 - Future Development of 297-8
 - In the Economy 289
 - Productivity in 297
- Diversification 53, 165
- Dividend
 - Capital, Public 65
 - Co-operative 323
 - Definition of 38
 - Interim 38
 - Payment of 38, 473
 - Warrant 39
- Divisible Credits 487
- Dock Receipt 393
- Documentary Credits 486
- Documents Against Acceptance/Payment 391
- Documents of Title 481
- Dormant Partner 14
- Draft
 - Bankers' 429
 - Documentary 400
 - Sight 519
 - Terms 389
- Drawback 415
- Duopoly 50
- Duplicating 83
- Duty Paid 389
- DX Accounts 474
- Economy of Effort, Wholesaler and 304
- Efficiency, Audit of 66
- Efficiency, Index of 297
- Electricity Act* (1947) 63
- Electricity Council 63
 - Research Centre 63
 - Supply Research Council 63
- Electronic
 - Calculators 84
 - Data Processing 298
 - Notebooks 78
 - Scanners 83
- Eligible
 - Liabilities 458
 - Reserve Assets 458
- Employment
 - Dismissal of 204
 - Engagement of 200-1
 - Records of 75-6
 - Rights of 202-4
- Employment
 - Civil 8
 - Contract of 201-2
 - Legislation 200-7
- Employment Protection (Consolidation) Act* (1978) 202, 203, 204, 231
- Endorsement
 - Bills, of 436
 - Blank, in 436
 - Conditional 436
 - Forgery of 449
 - Insurance Policy, of 283
 - Partial 436
 - Restrictive 436
 - Rules of 451-2
 - Special 436
- Endowment Assurance 279
- Engineering Insurance 278
- Enterprise 3
- Enterprises, Public 60-7
- Entrepreneur 4
- Entry
 - By Importers 400, 409
 - For Warehousing 412-13
- Equal Pay 202
- Equal Pay Act* (1970) 202
- Equitable Mortgage 481
- Equity Capital for Industry, Ltd. 161
- Equity, Company's 34, 502
- Errors and Omissions Excepted (E. & O.E.) 105
- Estate Duties Investment Trust, Ltd. 485, 497

- Estate, Joint 20
- Estate, Separate 20
- Estimate 101
- Estoppel 198
- Euro-Currency and Euro-Dollar Market 493, 526
- Euro-Dollars 493
- European Communities Act* (1972) 26, 383
- European Economic Community (E.E.C.) 383, 399
 - Activities of 58-9, 348, 383
 - Competition and 58-9, 383
 - Currency Stabilisation and 525-6
 - Imports and 383, 416
- European Monetary Co-operation Fund 525
- European Unit of Account (E.U.C.) 525-6
- Evolutionary Theory of Change in Distribution 298
- Ex All 509
- Exception Schedule, V.A.T. 413
- Excess Fire Policies 275-6
- Exchange
 - Clauses 519-20
 - Clearings 521
 - Control 525
 - Essence of 3
 - Forward 519
 - Fluctuations 518
 - Foreign 514-26
 - Forward 519
 - International 522-6
 - Pegging 521
 - Rates, Official 516
 - Basis of 515
 - Restrictions 517, 521
 - Risks, Elimination of 521-2
 - Stabilisation 520
 - Transactions 516-17
- Exchange Control Act* (1947) 525
- Exchange Equalisation Account 456, 520
 - Act (1979) 456
- Exchequer Equalisation Grants 221
- Ex Div. 509
- Execution of Orders 313-15
- Exempt Private Companies 37
- Ex Gratia* Payments 284
- Exhibitions 120
- Expectation of Life 280
- Expenditure Survey, Family 423
- Expenses and Taxation 215
- Export
 - Agents 384, 385
 - Associations 385, 386
 - Commission Agents 384-5
 - Credit Claims Procedure 405
 - Credits Guarantee Department 254, 279, 404, 522
 - Credits Insurance 404-5
 - Direct 386
 - Indirect 386
 - Inquiries 386
 - Licences, Specific and General 368
 - Licensing Branch 368
 - Markets 379
 - Merchants 384, 385
 - Orders 389
 - Packing and Marketing for 391
 - Quotations 386-7
- Exporter, Payment of 389
- Export Guarantees and Overseas Investment Act* (1978) 404
- Exporting 384-405
 - Practice and Procedure 385-405
 - Rc- 414
- Express Services, Parcels 352, 366
- Ex Rights 509
- Ex Ship 388
- Extraordinary General Meetings 43
- Extrapolation Trend 97
- Ex Warehouse 102
- Ex Works Price 101
- Factors 250
- Factors of Production 3-4
- Facultative Reinsurance 284-5
- Fair Trading Act* (1973) 58, 340, 341
- Fair Trading, Director-General of 57, 58
- Fair Trading, Office of 342
- Family Law Reform Act* (1969) 191
- Farmers' Co-operatives 248
- Federal Reserve System 453
- Fidelity Insurance 278
- Fiduciary Issue 455
- Filing 80-1
 - Accounts of 37
 - Alpha-Numerical 81
 - Geographical 81
 - Lateral and Vertical 80
 - Numerical 81
 - Subject 81
- Finance
 - Bill 208
 - Companies 500
 - Houses Association 500
 - Houses Deposit Markets 493
 - Long-Term 497-8
 - Money and 419-526
 - Obtaining of 153
 - Planning of 148-85
 - Services 6
 - Short-Term 490-5
 - Trade, of 476-89
- Finance Act* (1965, 1972), 216, 217, 218
- Finance Corporation for Industry, Ltd 161, 484
- Finance For Industry, Ltd. 161, 478, 484, 497
- Financial Accounting 148-85
- Financial Times Share Index 371
- Finished Stock
 - Budget 139
 - Turnover 173
- Fire Insurance 259, 274-7

- Policies 274-6
 - Adjustable 276
 - Average 275
 - Claims Under 276-7
 - Excess 275-6
 - Floating 275
 - Ordinary 274
 - Valued 276
- Fire Precautions 310
- Firm
 - Multi-National 53, 493
 - Multi-Product 52-3
 - Name of 18, 19
- Firm Officer 101
- Fixed
 - Assets 148
 - Capital 148
 - Costs 130
 - Credits 487
- Fleet Policies 266
- Flexible Trusts 499
- Floating
 - Capital 148-9
 - Policies 266, 275
 - Pound 516
- Foreign
 - Bills 432
 - Currency Accounts 519
 - Exchange 514-26
 - Market, London 514
 - Table 517
 - Money Orders 427
 - Remittances 477
 - Trade
 - Britain's 375-83
 - Finance of 463
 - Letters of Credit in 401, 485-9
 - Theory of 375-6
- Forfeiture of Shares 36
- Forgery of Cheque 449-50
- Forward Exchange 519
- Forward Agents 385
- Forward Sale 257
- Founders' Shares 33
- Franchising 115
- Franco 389
- Franking Machines 365
- Free Alongside Ship (F.A.S.) 388
- Free Collections 365
- Free Docks 388
- Freefone 371
- Free of Particular Average (F.P.A.) 397
- Free on Board (F.O.B.) 388
- Free on Rail (F.O.R.) 102, 388
- Free on Trucks (F.O.T.) 388
- Freepost Service 364
- Freight
 - Agent, Air 402
 - Back 357
 - Dead 397
 - Forward 357, 394
- Rates
 - Air 362
 - Rail 353
 - Sea 356-8
- Release 410
- Freightliners, Ltd 348, 351
- Full-Cost Pricing 64
- Full Service Advertising 121
- Full Service Wholesaling 294
- Funds, Transmission of Abroad 516-17
- Futures 241-2, 255-6, 519
- Gas Acts* (1948 and 1972) 62
- Gearing
 - Capital 159-60
 - Ratio 159
- General
 - Acceptance 437
 - Average 270-2, 397
 - Bond 414
 - Cargo Ship 356
 - Clearing 463, 464
 - Council of T.U.C. 206
 - Import Restrictions 415
 - Index of Retail Prices 422
 - Manager 70
 - Meetings 43-4, 46
 - Partners 14
 - Prices, Level of 422
 - Special Commissioners, and 216
 - Third Party Risks 278
 - Wholesaler 294
- General Agreement on Tariffs and Trade (G.A.T.T.) 382-3, 416
- General Conditions of Rail Carriage 353
- Gilt-Edged Market 480, 499, 502
- Giro
 - Bank 109
 - Credit 109
 - National 430
 - Postal Cheques 430
- Gold, and Note Issue 455
- Good Faith, in Insurance 258-9
- Goods
 - Branded 50-1, 303, 312-13
 - Comparison 338
 - Convenience 338
 - Merchantable Quality of 341
 - On Consignment 406-7
 - Protected 343
 - Release of Imported 409-11, 415-16
 - Returned 314-15
 - Shipping 392-400
 - Shopping 338
 - Speciality 338
 - Title to 481
 - Unsolicited 341
- Goodwill 175-85
 - Annuity Method 181-2
 - Attached to Persons 176-7
 - Capitalisation Basis of 180

- Goodwill, cont.
 Companies', Valuation of 182-5
 Definition of 175
 Sliding Scale 181
 Types of 175-6
 Valuation of 179-85
- Government Broker 502
- Grade, Marketing by 237
 Advantages of 238
- Grading of Bills 491
- Grants
 Exchequer 220, 221
 Rate Deficiency 221
- Gross Premium 280
- Gross Profit Ratio 173
- Gross Yield 513
- Groups, Voluntary Trading 317
- Guarantee 480
 Cards, Cheque 430
 Comprehensive 404
 Definition of 480
 Payments, Statutory 204
- Hague Rules* 395
- Handling, Mechanical 310
- Health and Safety Commission 207
- Hedging 256-7
- Hire-Purchase 342-4
- Holder in Due Course 434-5
- Holding Company 51-2, 166
- Holding Out 14-15
- Home Selling 331
- Honour Policies 267
- Horizontal Integration 53, 165
- Hot Money 518
- Hull Policies 269
- Hydrofoils and Hovercraft 356
- Hyperinflation 424
- Hypermarkets 326-7
 Advantages and Disadvantages of 327
 Characteristics of 326
 Superstores, Differences between 327-8
- Hypothecation, Letters of 401, 481
- Immediate Discharge of Bankrupt 233
- Import, Export and Customs Powers (Defence) Act* (1939) 415
- Importing 406-16
 Buying Offices 385, 386
 Procedures 407-13
- Imports
 Against Orders 406
 Consignment on 406-7
 E.E.C. Objectives and 416
 Licences 415
 List 408
 Markets 379
 Prohibited and Restricted 415
 Release of 409-11, 415-16
 V.A.T. and 413
 Zero-Rated 413
- Impulse Buying 335
 Classification of 335
- Imputation System of Tax 217
- In Bond 389
- Income and Corporation Taxes Act* (1970) 213
- Income Tax 212-16
 Administration of 216
 Exemptions from 214
 Local 222
 Necessary Expenses and 215
 Personal Reliefs from 214-15
 Schedules 213-14
- Income Tax (Employments) Act* (1943) 215
- Inconvertible Notes 421
- Incorporation, Certificate of 29, 505
- Indebtedness
 International, Discharge of 514
 Settlement of through Banks 476-7
- Indemnity 109, 260
 Certificate of 412
 Clause 480
 Letter of 395
- Indent 389, 390
- Independent
 Retailer 316
 Stores 316-17
 Unions 202
- Index
 Cost of Living 422
 Numbers 422-3
 of Output 297
 of Saturation 333
 of Wholesale Prices 422
- Indexing 82
- Indication, Letter of 488
- Indirect Taxation 210-11
- Industrial
 Occupations 4, 5
 Tribunal 203, 204
- Industrial and Commercial Finance Corporation 161, 484
- Industry Acts* (1975 and 1979) 66
- Inertia of Large Numbers, Law of 124
- Inflation 424
 Cost-Push 424
 Demand-Pull 424
 Hyper- 424
 Persistent 42
- Inland Bills 431, 432
- Inland Post 363-7
- Inland Telegrams 369
- Inland Revenue
 Board of 261
 Commissioners of 216
- Inquiries 100, 386
- Inscribed Securities 507
- Insolvency Act* (1976) 224, 225, 227, 233
- Inspectors of Taxes 216
- Institutional Investors 492, 500
- Insurable Interest 259-60
- Insurance 258-85

- Accident 259, 277-9
- Arbitration 261
- Bad Debts 254, 278-9
- Basis of 258-60
- Certificates of 267
- Consequential Loss 277
- Contribution 261
- Export Credits 404-5
- Exported goods 397
- Fire 259, 274-7
- Good Faith in 258-9
- Indemnity 260
- Marine 262-73
- Personal Accident Sickness 278
- Principles of 258-61
- Services 6-7
- Terms 282-4
- Types of 252
- Integration 53, 165-6, 302
 - Holding Company and 166
 - Horizontal 53, 165
 - Vertical 53-4, 165
- Interbank Market, Sterling 492
- Interlocking Directorates 51
- Intermediaries
 - Business 247-57
 - Relationships of 250-1
 - Types of 249-57
- Intermediate
 - Credit 477-8
 - Days 510
- International Acriadio, Ltd 361
- International Air Transport Association 362
- International Bank for Reconstruction and Development 455, 522, 524
- International Exchange 522-6
- International Indebtedness, Discharge of 514
- International Monetary Fund 380, 416, 455, 456, 516, 522-4
 - Act (1979) 523
 - Control of 522, 524
 - Drawings on 380, 523
 - Operations of 523-4
- International Rail Transport 354
- International Reply Coupons 368
- International Road Transport 349-50
- International Subscriber Dialling (I.S.D.) 371
- International Trade 375 *et seq.*
- International Transferred Accounts 369
- Interpolation 135
- Investment, Return on 293
- Investment Trusts 498-9
- Investment Yield, Calculation of 513
- Investor, Requirements of 154-5
- Investors, Institutional 498, 500
- Invisible Trade 381
- Invoice 104, 105-6
 - Consular 400
 - Copy 104
 - Pro Forma* 105, 106, 407-8
 - Shipping 398, 399
- Invoicing
 - Computer, by 94
 - I.O.U. 441
 - Iron and Steel Act* (1967) 62
 - Issued Capital 158
 - Issuance of Notes 455-6, 463
 - Issues, Capital 473
 - Issues of Shares, Bonus 39
 - Issuing House 30, 497
 - Itemised Pay Statement 203
- Jettisoning Cargo 271, 397
- Jobbers 503-4
- Jobber's Turn 504
- Joint Estate 20
- Keeping House 224
- Kimball Tags 95
- Kiosks 330-1
- Lading, Bill of 393-6
- Land as Security 481
- Landed 389
- Landing Order 413
- Large-Scale Production 9
- Law of Property Act* (1925) 190
- Law Reform (Frustrated Contracts) Act* (1943) 198
- Lay Days 396
- Lay-Out in Stores 334-5
- Leasing of Departments 321
- Ledger-Posting, Mechanised 85-6
- Legal Aspects of Business 186-234
- Legal Mortgage 481
- Legal Tender 420, 425
 - Limited 420, 425
 - Unlimited 420, 425
- Lenders of Last Resort 453
- Letter
 - Airway 366
 - Credit, of 401, 485 9
 - Circular 488
 - Limited 488
 - Traveller's 488
 - of Allotment, 164
 - of Hypothecation 401, 481
 - of Indication 488
 - of Indemnity 395
 - of Subrogation 272-3
 - Railway 366
 - Registered 367, 368
- Letters, Delivery of 363
- Liability
 - Limitation of 28
 - Third Party 277
 - Unlimited 23-4
- Licences, Imports 415
- Lien
 - Bankers' 471
- Life Assurance 259, 279-82
 - Claims 281
 - Premiums 279-80

- Life, Expectation of 280
- Life Policies as Security 481
- Light Pens 93, 95
- Limitation Acts* (1939-1975) 196
- Limitation of Liability, Clause of 28
- Limited Company 11, 12, 23
 - Advantages and Disadvantages of 48-9
- Limited Liability, Concept of 28
- Limited Liability of Partner 18-19
- Limited Partnership 18-19
- Limited Partnership Act* (1907) 18
- Limited-Service Wholesaler 294
- Limited Tender 420, 425
- Linear Optimisation 96
- Line Organisation 71
- Liner Trains 350
- Liquidation of Company 47
 - Creditors' 47
 - Members' 47
 - Voluntary 47, 167
- Liquid Capital 150-1
- Liquidity 482
- Liquidity Ratio 172-3
- Lloyd's 262 *et seq.*
 - Agents 262
 - Loading List 360
 - Register of Shipping 359
- Loans
 - Account 468, 479
 - Bank, Types of 462, 478-9
 - Policies, on 281
- Local Authorities
 - Market in Loans 493
- Local Clearings 463
- Local Rates and Taxation 220-2
- Location
 - Site 332-4
 - Store 332
 - Warehouse 308-9
- Loco Price 101
- London
 - Clearing Bankers, Committee of 463
 - Commodity Exchange 416
 - Discount Market Association 491-2
 - Foreign Exchange Market 514
 - Interbank Offered Rate (L.I.B.O.R.) 526
 - Money Market 490-5
 - Stock Exchange 501 *et seq.*
 - Transport Executive 348
- Long-Term Credit 478, 485
- Long-Term Finance 497-8
- Loose Card Index 82
- Loss 270-2
 - Actual Total 270
 - Consequential 277
 - Constructive Total 270
 - Leaders 338
 - Partial 270-1
 - Prevention 339
 - Profits, of 277
 - Total 270
- M₁ 457
- M₂ 457
- MacMillan Committee 484-5
- MacMillan Gap 484
- Magazines 119
- Mail
 - Direct 120
 - Inwards and Outwards 79-80
 - Room 79-80
 - Transfer (M.T.) 429, 517
- Mail Order 328-9, 427
 - Advantages and Disadvantages of 328-9
 - Goods Appropriate to 328
 - Origins of 38
 - Types of 328
- Making-Up Day 510
- Management
 - Accounting 130-85
 - Company of 42-3
 - Definitions of 68
 - Merchandise 336-7
- Manager
 - Credit 74
 - General 70
 - Office 74
 - Personnel 74
 - Production 73
 - Publicity 73
 - Purchase 73
 - Sales 73, 99
 - Special 230
 - Transport 74
 - Works 73
- Managing Director 70
- Manifest, Ship's 396
- Manifolding 85
- Manpower Services Commission 207
- Manufacturer, Wholesaler and 302-3
- Margin of Safety 133
- Marine Insurance 259, 262-73
 - Claims Under 269-73, 399
 - Companies 263
 - Formation of Contract of 263-4
 - Policy of 266-7, 283
- Marine Insurance Act* (1906) 265, 267, 268, 271
- Mark-down Prices 337-8
- Mark, Export Agent's 385-6
- Markup Prices 337
- Market
 - Auctions 242-3
 - Aggregation 125
 - Capital 496-513
 - Definition of 239
 - Discount 491-2
 - Euro-Currency and Euro-Dollar 493
 - Finance Houses Deposit 493
 - Foreign Exchange 514-26
 - Futures 241-2
 - Gilt-Edged 480, 499, 502
 - Lists 239
 - Local Authority Loans 493

- Money 490-5
- New Securities 496, 497-501
- Organisation 241
- Price 240, 508
- Research 124, 126-8
- Segmentation 125, 337
- Spot 241
- Stalls 329
- Sterling Certificates 492-3
- Sterling Interbank 492
- Survey Report 128
- Test 128
- Marketing
 - Advertising and 110-29
 - Benefits of 111
 - Definition of 110
 - Grade, by 237
 - Integrated 111
 - Mix 111
 - Objectives 123
 - Operation, Planning of 123-8
 - Personnel 129
 - Sample, by 124-5, 237
 - Strategy 123-4
- Markets
 - Commodity 239, 241-6
 - Parallel 492-3
 - Produce 239
 - Raw Materials 239
 - Relationship of 238
 - Risk-Bearing and Insurance 237-85
 - Secondary Money 492-3
 - Wide 239-40
- Marking Cheques 450
- Marks, Agents' 385-6
- Master Budget 137, 142-3
- Maternity Rights of Employees 203
- Mate's Receipt 393
- Mechanical Handling 310
- Media, Advertising 119-20
 - Characteristics of 119-20
 - Department 120
 - Classification of 119
 - Major 119
 - Minor 120
- Meetings, of Company
 - Annual General 43
 - Extraordinary General 43-4
 - General 43-4, 46
 - Statutory General 43
- Membership of Company, Termination of 35-6
- Members of Company
 - Liquidation by 47
 - Register of 35
 - Rights, Variation in 164
- Memorandum of Association 15, 24 *et seq.*, 28
 - Specimen Form of 26-7
- Memorandum of Deposit 481
- Merchandise
 - Management 336-7
 - Mix 337
 - Operations 334-40
 - Own-Label 323
- Merchandising 116, 334-40
- Merchant Fleet 355-6
- Merchants
 - Export 384, 385
- Merchant Shipping Acts* (1970, 1979) 201, 358
- Mergers 51, 198
- Microfilms 82-3
- Middlemen 247-57
 - Elimination of 247-8, 302
- Minimum Lending Rate 457-8
- Minimum Subscription 31
- Mining Research and Development Establishment 62
- Misconduct and Dismissal of Employee 204
- Mixed Economy 60
- Mixed Policies 266
- Mobile Shops 330
- Monetary Policy 456-9
- Monetary System, British 425-6
- Money 419-30
 - at Call 466, 491
 - Characteristics of 420-1
 - Definition of 419
 - Finance and 419-526
 - Forms of 419
 - Functions of 420
 - Hot 518
 - Methods of Remittance of 426-30
 - Near- 419
 - Value of 422-5
- Money Orders 427
 - Foreign 427
 - Telegraph 369, 427
- Money, Market 490-5
 - Borrowers 496
 - Composition of 490
 - Control of by Bank of England 490, 493
 - International Aspects of 494 5
 - London 490
 - Parallel 492-3
 - Work of 490
- Monopolies and Mergers Act* (1965) 57
- Monopolies and Mergers Commission 57, 58
- Monopolies and Restrictive Practices Act* (1948) 57
- Monopolies and Restrictive Practices Commission 57
- Monopoly 50-1
 - Absolute 50
 - Definition of 50
- Monopsony 50
- Mortgage Debentures 39, 40
- Mortgage, Equitable and Legal 481
- Mortgages and Charges, Register of 41, 46
- Motor Insurance 277-8
- Multi-nationals 53, 493
- Multiple Stores 317-20
 - Advantages and Disadvantages of 318, 320
 - Buying and Selling Operations of 318

- Multiple Stores, cont.
 - Development of 317-18
 - Organisation of 319
- Multi-Product Firms 52-3
- Mutual Clubs 273
- Naked Debentures 39
- National
 - Association of British Manufacturers 207
 - Bus Company 348
 - Coal Board (N.C.B.) 57, 61-2
 - Coal Board (Ancillaries) Ltd 61
 - Coal Board (Coal Products) Ltd 61
 - Debt 453, 455
 - Debt Commissioners 475
 - Development Council 66
 - Dividend Stamp Scheme 323
 - Dock Labour Board 359
 - Economic Development Council 207
 - Enterprise Board 66
 - Freight Corporation 348
 - Giro 430
 - Loans Fund 208, 455
 - Ports Council 359
 - Savings Bank 474-5
- Nationalisation 56, 66-7
- Nationalised Industries 60 *et seq.*
- Natural Gas 62
- Near-Money 419
- Negative Clearance 59
- Negligence of Banker 451
- Negotiable Instruments 433
- Net Cash 102-3
- Net Worth to Indebtedness, Ratio 174
- Nominal Capital 28
- Non-Commercial Credits 488-9
- Non-Cumulative Preference Shares 157
- No-Par Value Shares 158
- Note
 - Air Consignment 402
 - Bond 414
 - Bought and Sold 104
 - Circular 489
 - Contract 511
 - Cover 282-3
 - Credit 106
 - Debit 106
 - Issuing 455-6
 - Out of Charge 409
 - Shipping 392-3
 - Weight 412
- Notes
 - Bank 421
 - Issued of 455-6, 463
 - Promissory 440-1
- Notice
 - Bankruptcy 225
 - Periods of Employment, in 201-2
- Not Negotiable 426, 443, 444, 446
- Not Transferable 444
- Novation 17
- Numbers, Index 422-3
- O & M 76
- Objective, Principle of the 69
- Objects Clause 25-6
- Occupational Distribution 4-8
- Offer and Acceptance 187-9
- Offer, Firm 101
- Offer for Sale of Shares 30
- Office 71-6
 - Machines 77-8, 82-7
 - Manager 74
 - Planning of 87
 - Premium 280
 - Premises and Lay-out 72
 - Registered, of Company 25
 - Routines and Equipment 77-88
 - Staff, Duties of 73-6
 - Work of 87-8
- Office of Fair Trading 342
- Official List, Stock Exchange 505, 506-7, 51
- Official Receiver 226, 229-30
- Oil Terminals 360
- Oligopoly 50
- Omnibus Credits 486
- One-Stop Shopping 326
- On Rail 102
- Open
 - Account 429
 - Account Policies 279
 - Cheque 444
 - Covers 264-5
 - Market Operations 458
 - Policies 266
- Opening a Cheque Crossing 444-5
- Operational Research by Computer 96-7
- Operations
 - Arbitrage 253, 518-19
 - Merchandising 334-8
 - Retailing 332-40
- Optimum Size of Productive Unit 55
- Option
 - Call 512
 - Dealing 512
 - Put 512
 - Trading Shares 502
- Order 103, 389
 - Adjudication 229
 - Computer use in 315
 - Delivery 413
 - Department 104
 - Departmental 104
 - Dissolution, for 234
 - Execution of 104-5, 313-15, 391
 - Export 391
 - Form 103
 - Landing 413
 - Obtaining 385-6
 - Receiving 225
 - Shipping 393
 - Ship's Delivery 410-11

- Standing, Bank 472-3
- Warehouse 104
- Warehouse-Keeper's 414
- Wholesale, Execution of 313-15
- Ordinary Debts 232
- Ordinary Shares 33, 157
- Organisation 68
 - and Management 68-76
 - Definitions of 68
 - for Economic Co-operation and Development (O.E.C.D.) 456
 - Linc 71
 - Principles of 69, 70-1
 - Staff 71
- Original Slip 263-4
- Origin, Declarations of 399
- Outer Capital Market 496-7
- Out of Charge Note 409
- Over-Capitalisation 56, 153
- Overdraft 429, 447, 478
- Overdue Bills of Exchange 437
- Over-Entry Certificate 410
- Overseas
 - Markets 379
 - Post 367-9
 - Trade 375-416
 - Britain's Markets 379
 - Britain's Pattern of 376-9
 - Britain's Supply Sources 379
 - Theory of 375-6
- Ownership, Forms of 10-67
- Own-Label Merchandise 113, 323
- Packaging 112
- Packing 314
 - Marking Exports and 391-2
 - Room Order 314
 - Shipping Agents 385
- Paid-Up Policies 281
- Pallets 362
- Parallel Money Markets 492-3
- Parcels Service 350, 352, 364, 368
 - Collection and Delivery (C. & D.) 352
 - Compensation Fee 364
 - Postage Forward 364
 - Red Star 352
 - To Call For (T.C.F.) 352
- Parking Facilities and Shopping 321
- Parliamentary Companies 23
- Partial Endorsements 436
- Partial Loss 270-1
- Participating Preference Shares 33, 157
- Particular Average 270, 397
- Partner
 - Active 14
 - Bankruptcy of 17, 20
 - Death of 17
 - Dormant 14
 - Duties and Authority of 16-17
 - Expulsion of 17
 - General 14
 - Incoming 17
 - Limited Liability of 18-19
 - Minor as 15
 - Non-Trading Firm, in 16
 - Novation and 17
 - Property of 20
 - Quasi- 15
 - Retiring 17
 - Rights of 16-17
 - Secret Profits and 17
 - Trading Firm, in 16
- Partnership 14-22
 - Advantages of 21
 - Articles of 14, 19
 - Banking 15
 - Bankruptcy of 20
 - Constitution of 15-16
 - Deed 14
 - Definition of 11, 14
 - Disadvantages of 21-2
 - Dissolution of 19-21
 - General Principles of 14
 - Implied 14
 - Limited 18-19
 - Name of 17-18
 - Registered Company and 14, 22
 - Unlimited Liability and 14
- Partnership Act* (1890) 14 *et seq*
- Par Valuc 507
- Pay As You Earn (P.A.Y.E.) 215-16
- Paying-In Book 468-9
- Payment
 - Cheque, by 446-7
 - Countermand of Cheque 448-9
 - Duc Course, In 438
 - Ex Grata* 284
 - Statutory Guarantee 204
 - Terms of 389
- Pay Statement, Itemised 203
- P/C 101
- Persona, in Law 10
- Personal Accident and Sickness Insurance 278
- Personnel Manager 74
- Petition in Bankruptcy 225-6
- Petroleum and Submarine Pipelines Act* (1975) 63
- Photo-Copying 83
- Physical Distribution Management (P.D.M.) 295, 298
- Picture Service 370
- Placing of Shares 30, 498
- Plant Utilisation Budget 139
- Plimsoll's Mark 358-9
- Point-of-Sale Advertising 116, 120, 334
- Policy
 - Accident Insurance 277-9
 - Assignment of 281, 481
 - Loans on 281
 - Marine Insurance 265
 - Paid-Up 281
 - Proof of Interest (P.P.I.) 267

- Policy, cont.
 - Reserve 280
 - Special 275-6
- Poll of Company Members 44
- Population, Trade Support 332-3
- Port Risk Policies 266
- Ports 359-60
- Postage Forward Parcels Service 364
- Postal
 - Address 365
 - Cheques 430
 - Codes 365
 - Orders 426-7
 - Packets, Insurance of 368-9
 - Rates Overseas Compendium 367
 - Remittances 426-30
- Postcode 365
- Post-Dated Cheque 442
- Posters 119
- Posting, Certificates of 367
- Post, Inland 363-7
- Post, Overseas 367-9
- Post Office 363-72
 - Guide 363, 427
 - Research 371-2
 - Savings Bank 474-5
 - Services 474-5
- Post Office Act* (1969) 363
- Postponed Creditors 232
- Poundage 426
- Power of Attorney 507
- Powers of Criminal Courts Act* (1973) 225
- Precautions
 - Against Fire 310
 - Against Theft 311
- Pre-Entry 400
- Preference Shares 33, 157
- Preferential Debts 231
- Premium
 - Gross 280
 - Insurance 280
 - Life Assurance 279-80
 - Office 280
 - Shares Issued at a 162, 507
- Pre-Preferential Debts 231
- Prestel 371
- Press 119
- Prevention of Fraud (Investments) Act* (1958) 170, 499, 505
- Price
 - Index Numbers 422-3
 - Lining 337
 - List 100
 - Loco 101
 - Maintenance, Resale 57
 - Market 240, 508
 - Quotations 387-9
 - Sale of Goods, in 340
 - Stock 155
 - Street 508
 - Striking 512
- Prices
 - Changing, Effects of 423-5
 - Current 101
 - General Level of 422
 - Stocks and Shares 508-9
 - Tape 508
- Pricing 112-13
 - Cost Plus 112-13
 - Customary 337
 - Determinants of 338
 - Loss-leaders 338
 - Mark-down 337-8
 - Mark-up 337
 - Price Lining 337
 - Psychological 337
 - Public Enterprises and 64-6
 - Retail 337-8
 - Scarcity 338
 - Slot 337
- Primage 398
- Private Branch Exchange (P.B.X.) 371
- Private Company 12, 37, 46-7
- Produce
 - Brokers 249
 - Clearing Houses 243
 - Markets 239
- Production 3-8
 - Budget 139
 - Definition of 3
 - Divisions of 7
 - Factors of 3-4
 - Manager 73
- Productivity
 - Distribution, in 297
 - Partial 297
 - Total 297
- Profit 171
 - Graph 136
 - Loss of 277
 - Reinvestment of 498
 - Super- 177-8
 - to Volume Ratio (P/V) 132
- Pro Forma Invoice* 407-8
- Program, Definition of 93
- Programming 93
- Prohibited
 - Articles 365
 - Restricted Imports, and 415
- Promissory Notes 440-1
 - Bills of Exchange and 441
 - Definition of 440
 - Liability on 440
- Promoter, Company 500-1
- Promotions 116-17
- Prompt 416
- Prompt Cash 102
- Prompt Day 245
- Proposal, Insurance 282
- Prospectus
 - Company 30-1
 - Contents of 31

- Definition of 30
- Statement In Lieu Of 33
- Protected Goods 343
- Protection and Indemnity Associations 273
- Protest, Captain's 399
- Proving Debts in Bankruptcy 230-1
- Proxies 44
- Psychological Pricing 337
- Public
 - Companies 12
 - Dividend Capital 65
 - Enterprises 12-13, 60-7
 - Expenditure 209
- Publicity Manager 73
- Public Passenger Transport 348
- Public Relations 122-3
 - Officer 74
- Punched Cards 86-7, 91
- Readers 90
- Purchase Manager 73
- Purchasing
 - Department 99
 - Power Parity Theory 515
 - Rights in I.M.F. 523
 - System 99
- P/V Pictures 370
- Qualified Acceptance 437-8
- Quality Control 88
- Quasi-Partners 15
- Queuing Theory 96-7
- Quota Restrictions 415
- Quota Share Re-Insurance 285
- Quotations 100, 386-8, 505
- Quoted Securities 480, 505
- Race Relations Act* (1976) 201
- Radcliffe Report 457
- Radio, Commercial 119
- Radio Telegraph and Phone 370
- Rail 350-4
 - Express Parcels Service 352
 - Freight Operations 351
 - On 102
 - Passenger Services 351
 - Transport, International 354
- Railx Service 366
- Railway
 - Letters 366
 - Rates 353
 - Technical Centre 351
- Railways Act* (1921) 350
- Range Plan 336
- Rates, Local 220-2
 - Deficiency Grants 221
 - Reform of 221-2
- Rates of Exchange 515, 517-18
- Ratio
 - Current 172
 - Gear 159
 - Gross Profit 173-4
 - Liquidity 172-3
- Ratios, Accounting 132, 170-7
- Reactor Laboratory 63
- Rebates, Deferred 357
- Receipt 108
 - Deposit 283
 - Dock 393
 - Mate's 393
 - Wharfinger's 393
- Receiver
 - Debenture Holders, for 41-2
 - Official 226, 229-30
- Receiving Order 226-7
- Reconciliation Statement, Bank 469-70
- Reconstruction 167-8
 - External 168
 - Internal 167
- Recorded Delivery 367
- Records, Employees' 75-6
- Redeemable Preference Shares 34
- Red Star Service 352
- Reduced Areas 334
- Reduction of Capital 36
- Redundancy
 - Fund 231
 - Meaning of 204
 - Payments 204
- Redundancy Payments Act* (1965) 204
- Re-Exporting 414
- Referees, Board of 216
- Refer to Drawer 448
- Reflation 425
- Registered Companies
 - Offices of 25
 - Partnership and 22
 - Types of 23-4
- Registered Post 367
- Registered Securities 480, 507
- Register of
 - Directors' Interests 46
 - Members of Company 35, 37, 46
 - Mortgages and Charges 41, 46
 - Shipping 359
 - Substantial Interests 46
- Registers of a Company, Statutory 46
- Registrar of
 - Business Names 18, 19
 - Companies 11, 29, 31, 73
 - Restrictive Trading Agreements 57
 - Shipping 358
- Registration of Company 29
- Registration of Business Names Act* (1916) 18
- Registration of Ships 358
- Regressive Taxation 211
- Regulated Agreement 343
- Re-Importation 415
- Reinsurance 284-5
 - Cover 284, 285
 - Facultative 284-5
 - Quota Share 285
 - Surplus 285

- Reinsurance, cont.
 - Treaty 284, 285
- Release, Freight 410
- Release of Imported Goods 409-11, 415-16
- Remittance
 - Banking 427-30
 - Cheques by Post 445-6
 - Money, Methods of 426-30
 - Postal 426-7
- Rendu 389
- Renunciation 438
- Replacement Theory 97
- Reply Coupon, International 368
- Report, Budget 144-5
- Report, Ship's 408
- Representation 283
- Required Rate of Return (R.R.R.) 65
- Resale
 - Loss Policies 279
 - Price Maintenance 57
- Resale Prices Acts* (1964, 1976) 57
- Research
 - Concept 127
 - Desk 127
 - Development Budget 139-40
 - Market 124
- Reserve, Policy 280
- Resolutions
 - Extraordinary 44
 - Ordinary 44
 - Special 36, 44
- Responsibility, Principle of 69
- Restricted Imports 415
- Restrictive
 - Endorsements 436
 - Practices 52
- Restrictive Trade Practices Acts* (1956, 1976) 57
- Restrictive Trade Practices Court 57
- Retail Buying 335-6
- Retail
 - Outlets 317-51
 - Percentage of Market 296
 - Types of 295-6
- Retail Prices, General Index of 422-3
- Retail Pricing 337-8
 - Determinants of 338
 - Types of 337-8
- Retailer
 - Differential Advantages of 332
 - Functions of 295
 - Wholesaler and 300-1
- Retailers' Co-operative Buying
 - Associations 248
- Retailing
 - Classification of 295-6, 316 *et seq.*
 - Operations 332-40
 - Performance, Measures of 338-9
 - Pricing 337-8
 - Structure 295-6
 - Theories of Development 298-9
- Returned Goods 314-15
- Return on
 - Capital Employed 171-2, 174
 - Investment 293
- Revolving Credits 487
- Rights
 - Issues 30, 163, 498
 - Special Drawing, in I.M.F. 523
- Ring of Perishables 335
- Rings 52
- Risk
 - Bearers and Business Intermediaries 247-57
 - Elimination of 254
 - Insurable 259
 - Third Party 278
 - Non-Insurable 261
- Risks Book 264
- Road Haulage 348
- Roads 347-8
- Road Transport 347-50
 - Advantages and Disadvantages of 348-
 - International 349-50
- Roll-On, Roll-Off Vessels 356
- Royal Charter, Companies 23
- Running Brokers 491
- Safety, Margin of 133
- Sailing Warranties 267
- Salc
 - Contract of 340-1
 - Forward 257
 - Sample, by 341
- Sale of Goods Act* (1893) 198, 340
- Sales
 - Account 416
 - After, Service 340
 - Budget 138-9
 - Department 99
 - Manager 73, 99
 - To Fixed Assets 174
 - To Issued Share Capital 174
 - To Net Worth 174
 - To Working Capital 174
- Salesmen 100, 114
 - Commission 249, 250-1
- Sample
 - Marketing by 124-5, 237
 - Sale by 341
- Sampling Techniques 125
- Sans Frais* 437
- Sans Recours* 437
- Saturation Index of Retailing 33
- Savings
 - Account 474
 - Bank, National 474-5
 - Internal 160
- Scarcity-Value Pricing 338
- Scheduled Territories 524, 525
- Schedules, Income Tax 213-14
 - A 213
 - B 213
 - C 213

- D 213-14
- E 214
- F 214
- Scheme of Arrangement 228
- Scottish
 - Co-operative Society, Ltd. 294
 - Transport Group 348
- Sea
 - Freight Rates 356-8
 - Transport 355-60
- Scalink 354
- Secondary Markets, Money 492-3
- Secretary of Company 42, 73
- Secured Creditors 232
- Securities
 - Bearer 480, 507
 - Buying and Selling of 510-11
 - Gilt-Edged 480
 - Inscribed 507
 - Market for New 496, 497-501
 - Quoted 480
 - Registered 480, 507
 - Sale Abroad 517
 - Unquoted 480
- Security
 - Advances, For 479-82
 - Collateral 481-2
 - Documents of Title, as 481
 - Guarantee as 480
 - Land as 481
 - Life Policies as 481
 - Loss Prevention and 339
 - Par Value 507
 - Stocks and Shares as 480
- Segmentation, Market 125-6, 337
- Select Committee on Nationalised Industries 61
- Selection of Staff 75-6
- Self-Service 306
- Selling 99-109, 113-14
 - Buying and 99-109
 - Cost Budget 140
 - Direct 248, 303
 - Home- 331
- Separate Estate 20
- Services
 - Consumer 7
 - Express 365-6
- Settlement, or Account, Day 510
- Sex Discrimination Act (1975) 201
- Shares
 - Allotment of 31-2, 505
 - Bonus 39, 163-4
 - Certificates 35
 - Classes of 33-4
 - Cumulative Preference 33, 157
 - Debentures and 34, 42
 - Deferred 33
 - Discount, at a 35
 - Dividends on 38-9
 - Forfeiture of 36
 - Founders' 33
 - No-Par Value 158
 - Offer for Sale of 30
 - Ordinary 33, 157
 - Participating Preference 33, 147
 - Placing 30
 - Preference 33, 157
 - Cumulative 33, 157
 - Non-Cumulative 157
 - Participating 33, 157
 - Redeemable 34
 - Premium, at a 34-5, 162
 - Prices of 508-9
 - Rights Issue of 30, 163
 - Transfer of 35, 37-8, 511
 - Transmission of 35-6
 - Warrants 38, 41
- Ship, Ex 388
- Shipment, Advice of 407
- Shipping
 - Agents 385
 - Bill 414
 - Book 389
 - Control of 358-9
 - Goods 392-400
 - Invoice 398-9
 - Lloyd's Register of 359
 - Note 392-3
 - Rates 356-8
- Ships
 - Cellular Container 356
 - General Cargo 356
 - Hydrofoils 356
 - Measurement of 358
 - Registration of 358
 - Roll-On, Roll-Off 356
 - Tanker 356
 - Tramps 356
- Ship's
 - Delivery Order 410-11
 - Manifest 396
 - Protest 399
 - Report 408
 - Telephone Service 370
- Shoplifting 339
- Shopping
 - Area 332
 - At Home 298
 - Goods 338
 - Magnet 321
 - One-Stop 326
- Shops 316-44
- Shorthand-Typists 75, 78
- Short-Term Credit 477, 485
- Shrinkage
 - Minimisation of 339
- Sight, Bill of 410
- Silicon Chips 98
- Simulation 96
- Site
 - Choice 97

- Site, cont.
 Location 309, 332-4
 Selection 309, 333-4
- Size of Business Unit 9-10, 50, 55
- Sliding Scale Method and Goodwill 181
- Slip
 Definite 263
 Original 263
 Closing 263-4
 Trader's Credit 428
- Small Packet Post 368
- Social Security Act* (1975) 231
- Socio-Economic Groups and Variables 126
- Sold Note 104
- Sole Traders 10-11
- Solvency, Declaration of 234
- Sources of Supply, Wholesalers' 304-5
- Span of Control, Principle of 69
- Special
 Commissioners 216
 Delivery 366
 Deposits 458
 Directives 458-9
 Drawing Rights 523-4
 Endorsements 436
 Manager 230
 Policies 275-6
 Resolution 36
- Specialisation, Principle of 69, 376
- Speciality
 Goods 338
 Wholesaler 294
- Speculation 251-7
 Foreign Exchange 518
 Illegitimate 252-3
 Proper 252
 Stock Exchange 511-13
- Speculators 251-7
- Split Consignments 411-12
- Spot
 Cash 102
 Market 241
 Rate 519
- Staff
 Business 73-5
 Manager 74
 Organisation 71
 Records 75-6
 Selection of 75-6
- Stags 512-13
- Stale Cheque 442
- Standing Order, Bank 473
- State Intervention 60
- Statement 107
 In Litu of Prospectus 33, 46
 of Affairs in Bankruptcy 227
- Station, At 101
- Statistical Regularity, Law of 124
- Statutory
 Companies 23
 Guarantee Payments 204
- Meeting 43
- Registers 46
- Stencils 83
- Stenotype Machines 78
- Sterling
 Area 525
 Certificates of Deposit, Market for 492-3
 Devaluation 516
 Exchange Value 516
 Interbank Market 492
- Stock
 Conversion of Shares into 38
 Convertible Loan 41
 Inventory, Computer Control of 95-6
 Prices of 508-9
 Shares and 38
 Shares as Security 480
 Transfer Form 507
 Turn 338-9
 Turnover 338
- Stock Exchange 168, 498, 501-13
 Backwardation 510, 512
 Brokers 503-4
 Clerks 502, 503
 Committee on Quotations 506
 Contango 509, 510
 Control and Management of 502-3
 Council 502-3
 Dealings for Cash 509
 Dealings for the Account 509
 Hammering of Defaulter 502
 Intermediate Days 510
 Jobbers 503
 Jobber's Turn 504
 London 501 *et seq.*
 Making Up Day 510
 Membership of 503-5
 Official List 505, 506-7, 511
 Official Quotations 505, 511
 Option Dealing 512
 Permission to Deal 505-6
 Provincial 504-5
 Securities, Trading In 510-11
 Settlement 509
 Settlement, or Account, Day 510
 Speculation on 511-13
 Ticket, or Name, Day 510, 511
 Traded Shares 502
- Stock Transfer Act* (1963) 511
- Store, Bill of 415
- Stores, Retail 316-44
 Lay-Out 334-5
 Location 332-4
- Street Prices 508
- Striking Off Name of Company 48
- Striking Price 512
- Subrogation 260-1
 Letter of 260, 272-3
- Subscribers' Trunk Dialling (S.T.D.) 371
- Subscription, Minimum 31
- Substantial Interests, Register of 46

- Supermarket 324, 326, 333-5
 - Advantages and Disadvantages of 326
 - Definition of 324
 - Operations of 326
 - Origins of 324, 326
- Super Profit 177-8
- Superstores 327-8
- Suppliers' Accounts, Payment of 107-8
- Surplus Reinsurance 285
- Surrender Values 280-1
- Survey, Certificate of 399
- Suspensive Discharge of Bankrupt 233
- Syndicates 52

- Table A 28-9
- Take-Over 51, 168
 - Bids 168-9
 - City Code on 169
- Tankers 356
- Tape Prices 508
- Tape Reader 90
- Tare 412
- Tariff 408
- Tax
 - Capital Gains 217-18
 - Commodity 210
 - Corporation 216-17
 - Definition of 208
 - Income 212-16
 - Unified 213
 - Schedules 213-14
 - Value Added (see Value Added Tax)
- Taxable Person 219
- Taxation 208-22
 - Basis and Principles of 208-11
 - Benefit Theory of 208
 - British System of 211-12
 - Canons of 209-10
 - Direct 210
 - Elasticity and 210
 - Impact of 210
 - Incidence of 210
 - Indirect 210-11
 - Local 220-2
 - Progressive 210
 - Receipts from 212
 - Regressive 211
 - Socio-Political Theory of 208
 - Yield of 212
- Taxes
 - Collectors of 216
 - Inspectors of 216
- Telecommunications 369-72
- Telegrams and Telegraph 369
 - Inland and External 369
 - Money Orders 369, 427
 - Transfers (T.T.) 429-30, 516
- Telephone Services 371
- Television 119
- Telex 369-70
- Tender 101

- Legal 420, 425
- Terms
 - Draft 389
 - Payment, of 389
 - Trade, of 381-2
- Test Market 128
- Theft, Insurance against 278
- Theft, Precautions against 311
- Thermal Copiers 83
- Third Party
 - Liability 277
 - Risks 278
- Ticket, or Name, Day 510, 511
- Time
 - Charters 356
 - Policies 266, 279
- Title
 - Documents of, as Security 481
 - Goods, to 481
- To Call For Parcels Service (T.C.F.) 352
- Token Coins 421
- Total
 - Distribution Cost (T.D.C.) 347
 - Loss 270
- Town Clearing 463
- Trade
 - Balance of 379
 - Charge Form 366
 - Description 341
 - Discount 103, 113
 - Fairs 120
 - Finance of, by Banks 477-89
 - Foreign 5, 6
 - Invisible 381
 - Occupations 5
 - Overseas 375-416
 - Support Population 332-3
 - Terms of 381-2
 - Visible 381
- Trade Descriptions Act* (1968) 340, 341
- Trader's Credit Slip 109, 428
- Trade Union
 - Membership 206
 - Rights of Members 202-3
- Trade Union and Labour Relations Act* (1974) 202, 203, 205
- Trades Union Congress (T.U.C.) 206-7, 422
- Trading
 - Account, Budgeted 143
 - Certificate 32-3, 505
 - Plan 336
 - Groups, Voluntary 317
- Trains 350 *et seq.*
- Tramps 356
- Transfer
 - Air Mail 429
 - Credit 109, 428
 - Mail 429
 - Risk 404
 - Shares 37-8, 511
 - Telegraphic 429-30, 516

- Transferable and Divisible Credits 487
- Transshipment 414
- Transmission of Shares 35-6
- Transport 347-62
 - Air 360-2
 - Canal 355
 - Communications and 347-62
 - Economy and 347
 - Industries 6
 - International Routier System (T.I.R.) 349
 - Manager 74
 - Ocean 358
 - Public Passenger 348
 - Rail 350-4
 - Road 347-50
 - Sea 355-60
- Transport Acts* (1947, 1962, 1968) 348, 350, 353
- Transportation Systems, Ltd 351
- Travellers'
 - Cheques 488
 - Letters of Credit 488
- Treasury Bills 457, 458, 490, 491, 494, 509
- Treasury Bills Rate 491
- Treaty of Rome* (1957) 60, 61, 383, 416
- Treaty Reinsurance 285
- Trend Extrapolation 97
- Tribunal
 - Industrial 203, 204
 - V.A.T. 219
- True Discount 439
- Trustee
 - Accounts 474
 - Bankruptcy, in 229, 230
- Trusts
 - Flexible 499
 - Investment 498-9
 - Unit 499-500
- Turnover 133, 173, 338-9
 - Calculation of 133-4
 - Policy, Whole 254
- Typewriter 79, 90
- Uberrima Fides* 258-9
- Ultra Vires* 26
- Unconfirmed Credits 486
- Uncontrollable Costs 137
- Under-Capitalisation 153
- Underground Rail Services 348
- Undertakings, Commercial, Types of 9-13
- Underwriter 262
- Underwriting 262, 501
- United Dominions Trust, Ltd 478
- Unfair Contract Terms Act* (1977) 341, 342
- Unfair Dismissal 204
- Uninsurable Risks 261
- Unions
 - Independent 202
 - Trade 202-3, 205, 206
- United Kingdom Atomic Energy Authority (U.K.A.E.A.) 63
- Unit Trusts 499-500
- Universal Postal Convention 368
- Unlimited Companies 23-4
- Unlimited Tender 420, 425
- Unquoted Securities 480
- Unsolicited Goods and Services Act* (1971) 340, 341
- Value Added Tax (V.A.T.) 96, 218-20, 317
 - Calculation of 220
 - Exemption Schedule 413
 - Exemptions from 219
 - Imports and 218, 413
 - Inputs and Outputs 220
 - Rates of 219
 - Registration of, and Appeals 219-20
 - Returns 220
 - Scope of 218
 - Services and 219
 - Tribunals 219
 - Zero Rating 218-19, 413
- Valued Fire Policies 276-7
- Variable Cost 130
- Variances 144
- Vehicle Insurance 277-8
- Vending Machines, Automatic 329
- Vertical Integration 53-4, 165, 248
- Viewdata 371
- Visible Trade 381
- Visual Display Units 92-3
- Voluntary
 - Liquidation 47, 167
 - Trading Groups 317
- Voyage
 - Change of 269
 - Charters 356
 - Policies 266
- Wages, Payment by Computer 94
- Warehouse
 - Automated 295, 311
 - Cash and Carry 115, 306, 317
 - Ex 102
 - Keeper's Order 414
 - Location of 308-9
 - Order 104
 - Organisation of 306-11
- Warehousing 295, 412-13
- Warranties 341
 - Insurance 283
 - Sailing 267
- Warrants 413
 - Crossed 475
 - Share 38, 41
 - Dividend 39
- Warsaw Convention* (1929) 403-4
- Waterways 355
- Waybill, Air 402
 - Weekly Bank Return 459-60
- Weighting 422
- Weight Note 412
- Wharfinger's Receipt 393
- Wheel of Retailing Theory 299

- Whole
 - Account Policies 279
 - Life Assurance 279
- Wholesale
 - Advertising 312-13
 - Link, Necessity of 303-4
 - Orders, Execution of 313-15
 - Organisation 305-15
 - Prices, Index of 422-3
- Wholesaler 115
 - Classification of Types of 294
 - Economy of Effort and 304
 - Full Service 294
 - Functions of 293-4, 300-1
 - General 294
 - Limited Service 294
 - Manufacturer and 302-3
 - Retailer and 300-1, 302
 - Sources of Supply of 304-5
 - Speciality 294
 - Trade 300-15
 - Warehouse of 306-11
- Wholesaling, Structure of 293-4
- Winding Up
 - Bankruptcy, in 234
 - Company, by Court 47-8
 - Voluntary 47, 234
- With Average (W.A.) 397
- Wool Futures Market 245
- Word Processors 79
- Work Flow 310
- Working Capital 149-50
- Works
 - Manager 73
 - Price, Ex 101
- World Bank 455, 522, 524
- XD (Ex Dividend) 509
- Yield 155, 513
 - Calculation of 155
 - Flat 513
 - Gross Running 513
 - Investment, Calculation of 513
 - Net Running 513
 - Redemption 513
- York-Antwerp Rules* 272
- Zero
 - Rate Schedule, V.A.T. 218
 - Rating 218-19, 413